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United States Department of State

Economic Reform in Poland: Status and Prospects

September 1989

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Summary

The new Solidarity-led government of Premier Tadeusz Mazowiecki has inherited an economy in crisis. In addition to the immediate problems of consumer goods shortages and inflation, economic performance suffers from formidable problems of industrial obsolescence, weak infrastructure, bad management, and low labor productivity. The stifling system under which Poles have labored for decades—and which they now have the opportunity to change—has left goods noncompetitive in export markets, limiting Poland's ability to modernize through imports or to service its crushing $39 billion debt.

Poland's economic plight has many roots—in the characteristic shortcomings of centrally planned economies; in mismanagement of development and import strategies; in efforts to placate worker unrest stemming from worsening living conditions; and in the shortcomings and inconsistencies of economic reform efforts of past Communist regimes. However, Poland is now laying the groundwork for dramatic new progress.

The new government has announced its intention of making economic stabilization its highest priority. Among its immediate tasks are bolstering food supplies and reining in the state budget. Success on these fronts will help garner worker support for economic reform measures that understandably will also mean uncertainty and hardship. The reforms also offer Poland a chance for improving living standards and—more important—for nourishing the seeds of democracy recently sown in Poland. At the same time, Poland also has to move quickly on developing an economic recovery program with the IMF.

In the long run, Poland faces the challenge of revitalizing and restructuring its obsolescent economy and restoring its international creditworthiness, while avoiding a further deterioration of living standards likely to jeopardize stability. Solidarity has said it intends to push forward a comprehensive package that reforms or privatizes state industry while encouraging new private industry—both foreign and domestic—as well as agricultural expansion. Poland must increase hard currency exports, develop capital markets, and encourage domestic savings.

The ability of the Mazowiecki government to retain good will, build public confidence, and convince the Poles that its reforms are more than just another set of consumer price hikes is crucial to its chances for success. The timing of reforms will be important if Mazowiecki is to avoid the mistakes made repeatedly by previous regimes. The government must lay the groundwork for a systematic reform of state-sector industry before moving too quickly to greater reliance on market mechanisms. Critical elements of this process will be dismantling central ministries, securing enterprise management compliance with reforms, legislating unemployment benefits, and privatizing at least part of state industry.

Mazowiecki also must be able to point to widespread support from the West in his efforts; most Poles realize that any significant restructuring of the economy will require infusions of financial and technical assistance that only the West can provide. Ideally, such aid should be linked to reform progress, both to avoid a repeat of Poland's borrowing mistakes of the 1970s and to help the new government justify any attendant hardships for workers and consumers.

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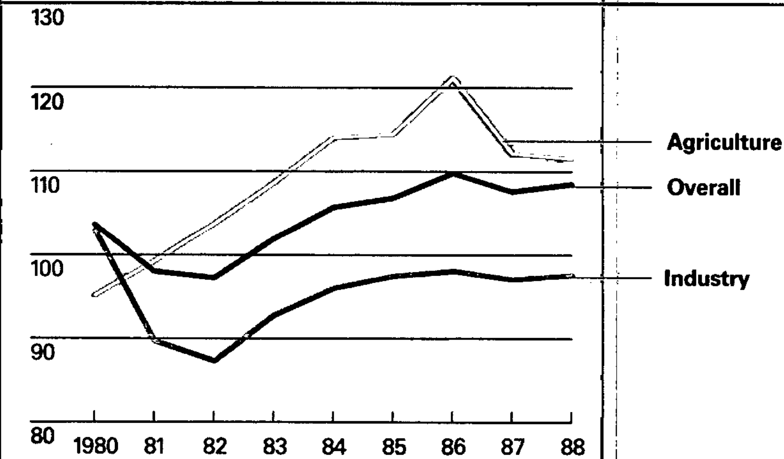
1. Selected Growth Indicators

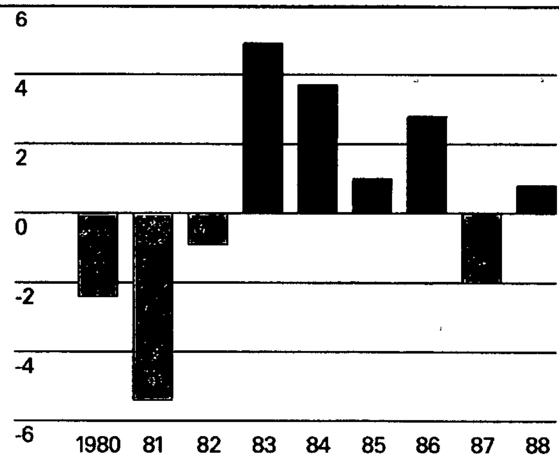
Selected GNP Indices, 1980-88

Index: 1975=100



Real GNP Growth, 1980-88

Percent



Economic Reform in Poland: Status and Prospects

Overview of Poland's Economic Performance

Poland's economic performance in the 1980s has been weak, and the decline has worsened in 1989. Real per capita income remains 10 percent less than a decade ago, and growth in the 1980s has brought output back only to the levels preceding the 1980-81 crisis. Inflation, spurred by price hikes last year and two subsequent waves of strikes, has risen from 70 percent annually at the beginning of 1989 to nearly 200 percent annually by midyear. Industrial output in the first half of 1989 was up only 1 percent and actually declined in the second quarter. Food deliveries appear to have increased this year, but panic buying and hoarding spurred by fears of even greater inflation have kept store shelves bare. The decontrol of food prices on 1 August propelled consumer prices upward and triggered further strikes, often for 100-percent pay increases, despite legislation promising to compensate workers fully for higher food costs.

A survey of financial macroeconomic indicators shows that:

- The state budget deficit has skyrocketed and now is nearly 55 percent of total revenues. The 1988 deficit was 200 million zloty; 1989's budget forecast a 1-trillion-zloty deficit; by May the deficit had reached 2.7 trillion zloty and even recent official forecasts for a 6-trillion-zloty deficit—in real terms, about triple the original forecast—now appear optimistic.

- Poland's money supply jumped over 60 percent in the first five months of 1989, from 2.7 trillion zloty to 4.4 trillion, as government expenditures ballooned—especially on consumer goods subsidies—while revenues fell behind schedule; enterprises struggling with new tax schedules and increased wage demands are increasingly behind on their taxes.

As a result, the value of the zloty has fallen dramatically in 1989. The official exchange rate rose from 503 zloty to the dollar in January to 1,350 in September. Although private sales of foreign currency have been legalized, the December 1988 black-market rate of 2,000 zloty to the dollar gave way by September to a commercial rate of 1,100 zloty to the dollar. The dramatic fall of the zloty has encouraged panic buying and hoarding as people buy hard currency and consumer goods as hedges against inflation.

A Sector-by-Sector Evaluation of the Economy's Problems

Poland's economic performance reflects the problems rife in virtually every economic sector. Industry is obsolescent, agriculture is constrained by a lack of inputs, trade is too low to finance modernization through imports, and private enterprise (outside of farming) and foreign investment are still too small to make a dent in Poland's economic problems.

Industry—The State Sector

Stalinist development strategies led to the development of a large state-owned manufacturing sector that produces 94 percent of Poland's nonagricultural output. Much of Poland's industry is concentrated in obsolete heavy industry. Most sectors are characterized by a handful of large enterprises—there are only 2,300 state enterprises in Poland, with as many as 10 establishments each—operating out of outdated factories that are extremely wasteful, are often heavy polluters, and produce low-quality goods uncompetitive on world markets. According to the World Bank, Polish factories on average use 2.5 times as much fuel and power per unit of output as do their Western counterparts. Moreover, declining investment allocations have led to capital stock wearing out faster than it can be replaced, and foreign exchange shortages limit imports of modern technology and even spare parts. Some plants have a net worth that is zero or negative by Western calculations, but they are kept operating in order to meet plan or trade commitments.

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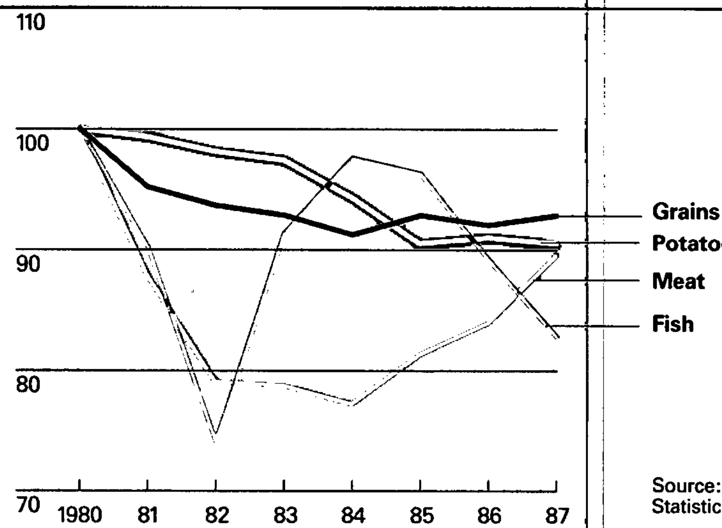
POLAND

2. Per Capita Consumption Indices

Index: 1980=100



Source: Polish Statistical Yearbook

Table 1
Poland: Wage Growth and Cost-of-Living Increases, 1981-88

Percent

	1981	1982	1983	1984	1985	1986	1987	1988 [a]
Nominal wage growth	27.3	51.3	24.5	16.3	18.8	20.4	21.1	84.4
Cost-of-living increase	24.4	101.5	23.1	15.7	14.4	17.3	25.5	74.0
Real wage growth	2.3	−24.9	1.1	0.5	3.8	2.6	−3.5	6.0
Per capita consumption growth [b]	NA	NA	NA	4	4	2	2	2

[a] Preliminary.
[b] Of goods paid for out of incomes (net of subsidies).

Source: Polish Statistical Yearbooks, statistical communiques.

State industry also is characterized by chronic and concurrent underemployment and labor shortages, the result of labor hoarding by factories more interested in meeting plan targets than in minimizing production costs. In 1988, for example, only 5,000 people were officially listed as looking for work, even while the state listed 280,000 job vacancies. In most state plants, however, many workers are idle much of the day. Education and training are readily available, and workers are free to change jobs, but Poland's housing shortages restrict labor mobility.

Domestic investment in state industry has tended to maintain heavy industry rather than to restructure the economy. Investment historically has been shaped by central planners and autonomous bureaucracies rather than by interest rates and profit potential. Until the 1980s most investment allocations came from direct grants from the state budget that did not need to be repaid. Ministries controlling the most physical assets—and which could make the most persuasive case for new investment in order to meet production targets—received the bulk of the annual state budget's investment allocations. As a result, Warsaw over the years has squandered considerable money in building and maintaining heavy industrial facilities of questionable worth.

The Poles readily acknowledge that a large part of the industrial base should be scrapped, but there is no ready substitute for what most of these plants produce. For example, even though the huge Nowa Huta plant uses inordinate amounts of energy supplies to produce steel, a shutdown either would require hard currency imports of steel well beyond what Poland can afford, or would mean steel shortages for other industrial plants that may be more efficient or productive.

Industry—Private Enterprise

Despite rapid growth in the 1980s the private sector in Poland still contributes only a small share—6 percent—of nonagricultural output. In addition to such traditional nonindustrial areas of operation as handicrafts, trade, and services, private enterprise now operates in such areas as small-scale manufacturing, transport, and even computer software and consulting. Poland's private-sector work force (not including 4 million private farmers) increased from about 600,000 in 1980 to just over 1 million by 1987, according to official statistics.

Private industry's growth probably would have been greater if not for numerous obstacles to its operation. Until this year privately owned enterprises had been heavily taxed and subjected to a 50-workers-per-shift ceiling on employment. Private enterprise also has suffered from bureaucratic obstacles—cumbersome registration and licensing procedures—and discrimination in favor of state enterprises for goods and services in short supply.

Agriculture

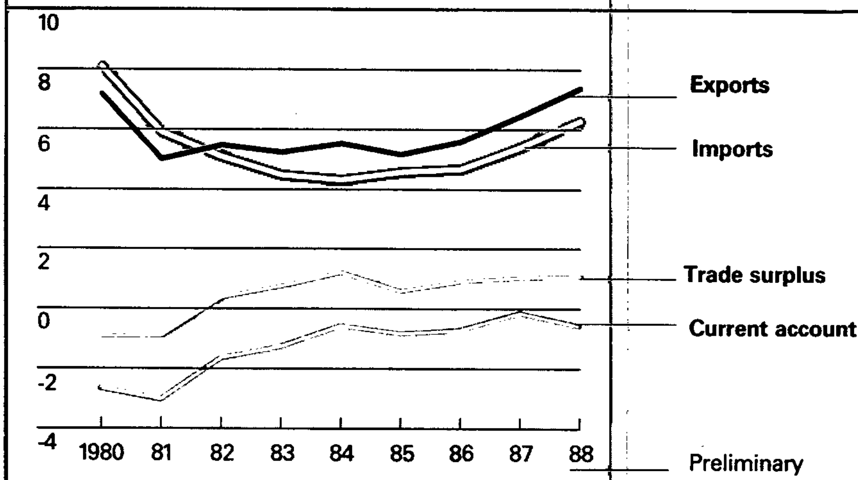
About 80 percent of Poland's agricultural lands are privately held—the result of failed collectivization efforts in the 1950s—which is the highest proportion in the Soviet

POLAND

3. Selected External Financial Indicators

Hard Currency External Accounts, 1980-88

Billion US $



Debt Coming Due 1989-95
(Principal Only)

Billion US $

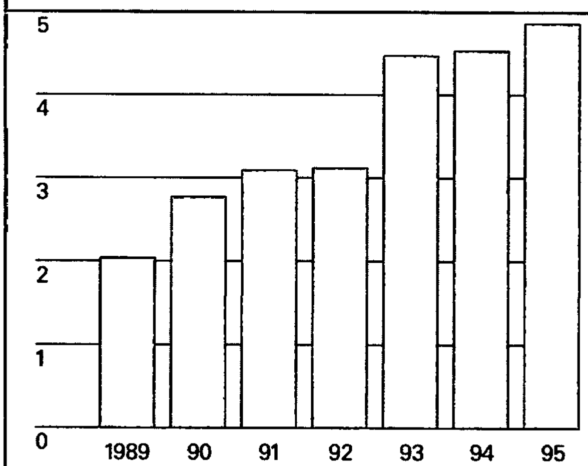


Table 2
Poland: Central Government Subsidies, 1983-88

Current billion zloty (except where noted)

	1983	1984	1985	1986	1987	1988
Total	**1,140**	**1,487**	**1,721**	**2,108**	**2,688**	**3,320**
Producer subsidies	564	738	861	925	997	867
Consumer price subsidies	576	749	860	1,183	1,691	2,453
Share of budget expenditures (*percent*)	40.0	41.4	31.6	39.7	42.1	33.2

Source: Polish Statistical Yearbooks.

Table 3
Poland: Pollution and Waste Problems

Million tons (except where noted)

	1975	1980	1986
Industrial dust emissions	18.021	25.77	27.259
Industrial gas emissions	0.563	0.664	0.677
Hazardous waste produced	136	165	179
Of which is stored:	66.2	78.5	85.4
Percent stored	48.7	47.6	47.7

Bloc. Farmers are constrained, however, by several factors. Restrictions on sales of land have kept farm sizes too small to capitalize on economies of scale; farm incomes have remained substantially—15 to 20 percent—below those of urban workers. A chief complaint of private farmers is that their ability to make a living is constantly squeezed by low procurement prices and high input prices. Moreover, the state monopoly on supply of agricultural inputs has inhibited private-farmer access to fuel, feed, and fertilizer. These inputs are not available in sufficient quantity to meet demand, and state farms typically receive preferential treatment in distribution. Another factor holding back agricultural output has been insufficient state investment in agricultural infrastructure; a lack of storage and processing facilities is responsible for large losses of harvested goods through spoilage.

Foreign Trade

Poland's foreign trade is modest for an economy of its size; total exports generally have made up about 15 percent of output through the 1980s, with about half going to Communist countries and half to the West. A sharp falloff in hard currency trade after Western trade sanctions were imposed when martial law was declared has been followed by near recovery to precrisis trade levels (see figure 3).

Poland has managed to maintain about a $1 billion trade surplus in recent years to help service its foreign debt. This has been done more by restricting imports than by expanding exports. The clampdown, however, has cut off access to badly needed inputs, spare parts, and repair services, thus limiting growth prospects for production and exports. Other factors limiting Polish export performance are poor product quality and weak world demand for Poland's leading exports, like coal and copper, which affect particularly Poland's ability to expand trade with the West. Poland's distorted price system, the overvaluation of its currency, and its trade obligations within CEMA also have worked against developing consistent efforts to increase hard currency earnings. Central authorities generally target goods for export to the West after netting out expected internal needs and CEMA trade obligations. Handling of exports by foreign trade organizations has tended over time to limit enterprise awareness of potential export markets and products.

Restrictions on export earnings also have worked against export growth. Hard currency restrictions have tended to discourage enterprises from seeking export markets; exporters receive only a small share of the hard currency earned by their exports, with the lion's share converted to zloty at the undervalued official rate. As a result, enterprises often have earned more zloty from domestic sales than from exports.

Hard Currency Debt. Poland's hard currency debt stood at $38.9 billion at the end of 1988—the highest in Eastern Europe. It has burdened the economy with debt service commitments ranging from $2-4 billion annually, and the failure of previous Polish governments to service this debt has precluded a renewal of access to new hard currency loans. Poland typically maintains a trade balance of about $1 billion, which usually helps to cover about 30 percent of its yearly repayment obligations. Polish leaders in effect have chosen to alienate creditors rather than to further curtail imports of capital goods.

Through the 1980s, Poland has managed to arrange reschedulings of its debt with both commercial and official (Paris Club) creditors. Failure to meet their commitments, however, has prevented past Polish governments from obtaining new credits to modernize or refurbish industry and to promote export expansion. Given Poland's dismal track record, Western creditors have been reluctant to extend new credits until Warsaw arranges an IMF standby agreement. A standby would give Poland access to IMF credits, but would also require Poland to subscribe to an adjustment program that includes economic reform measures.

The Evolution of Poland's Economic Problems—A History of Failed Reforms

By the end of the 1940s, Poland had established a centrally planned economic system on the Soviet model, with state-owned industry and central planning of production and trade. It embraced the typical Stalinist development model of rapid industrialization through high investment in heavy industry. It helped Poland emerge from wartime devastation, but soon gave rise to serious market imbalances, slowdowns in productivity growth, shortages of both production and consumer goods, inefficient use of technology and materials, and declining quality of production.

Communist leaders launched efforts to establish a more decentralized and market-oriented economy in 1956, 1974, 1982, and 1987. In each case, the central bureaucracy was able to regain control over economic decision making that had been transferred to the local or plant level. This was largely because of resistance on the part of the *nomenklatura*—local officials and managers appointed on the basis of party political credentials rather than economic or technical expertise. They have been generally opposed to reforms or unable to adjust to them, and have readily acquiesced in central ministry overtures to recoup authority.

In the 1970s, mismanagement of foreign debt helped undermine Poland's first attempt to look to the West for help. Taking advantage of the openings provided by Soviet-US detente, the government borrowed heavily from official and commercial creditors. The Gierek regime opted for a development strategy that relied on loan-financed imports of technology and equipment to develop new export industries. Warsaw counted on projected later growth in hard currency exports to repay the loans and speed Poland's modernization.

This development strategy failed for several reasons, some the result of Polish miscalculations and some the product of events beyond the control of Polish planners. In the former category, Poland failed to coordinate its various loans, and the surge in project construction created shortages and bottlenecks. Loans often fell due before plants were completed. Moreover, Polish ministries frequently imported inappropriate or incompatible technologies or failed to accurately assess export potential. Followup costs in imported materials or services frequently were overlooked, and output quality often was not suitable for export. In the latter category, projected new markets often failed to materialize because of reduced market demand from a recession-plagued West and unexpected competition from Asian newly industrializing economies. Similarly, a fall in world prices hurt Poland's hard currency earnings from its traditional exports of coal, copper, and sulphur.

Mounting foreign debt problems—debt soared to $25 billion by 1980—forced drastic cutbacks in imports of producer goods and imposition of austerity measures that placed great stress on the work force. Development of the

Solidarity movement in the period 1980-81 also contributed to social and economic disruptions that led to recentralization of economic decision making.

1981-86: The "First Stage" of Economic Reform

Objectives and Strategies. Following the imposition of martial law in 1981, Polish leader General Jaruzelski mounted another attempt to reform and revitalize the economy by decentralizing decisionmaking authority and introducing market mechanisms in the state sector. He apparently hoped he could make the *nomenklatura* respond to profit incentives and to market signals without excessively weakening party influence over economic decisions.

The 1981 Reform Project laid out proposals to incorporate a number of market-type mechanisms in the economy while scaling back the planning apparatus:

- Enterprises were to be "self-financed," meeting costs out of revenues and borrowing with interest from banks to finance expansion.

- Enterprises were to be "self-reliant," making their own production decisions, setting wages, and hiring and firing workers. Central ministry authority would be curtailed and the central plan scaled back to such priority areas as defense and CEMA trade commitments.

- Enterprises were to embrace worker "self-management," giving workers a voice in decisions at all but about 100 strategic plants.

Problems in Implementation. Despite a promising start, the Jaruzelski government failed to follow through in what came to be called the "first stage" of economic reform. Opponents of reform in the central ministries succeeded in watering down or eliminating a number of legislative proposals. Moreover, as problems later arose in implementing the laws that passed, the bureaucracy was able to modify policy to suit its needs. For example, financial reforms were intended to make enterprises cover their expenses out of revenues while paying a share to the state in taxes; money-losing enterprises eventually could be declared bankrupt and be shut down. The *nomenklatura*, however, managed to eliminate the threat of bankruptcy for most enterprises. Managers of money-losing enterprises asked for and received central ministry support in securing modified tax rates, special industry-specific exemptions, and other forms of special treatment.

Other efforts to impose financial discipline on enterprise managers also went astray. The Jaruzelski government shifted much of Poland's funding of investment projects from direct budget grants to bank loans that had to be repaid with interest. Over time, however, rate subsidies for "preferred" projects became the norm; few loans carried a real interest cost after accounting for inflation. Moreover, enterprises suffering unexpected shortfalls in revenue frequently could tap central ministry slush funds or lobby for refinancing.

Because of the imperfections in producer goods markets—shortages persisted for many goods—enterprise managers supposedly free to determine output generally found they had to bargain with various state ministries for needed raw materials. Over time this practice consolidated the power of the central ministries—who were best able to broker commodities in short supply—over individual enterprises. Lack of progress in decentralizing state control over the economy was not entirely the product of intent or ill will—inexperience with Western concepts of cost accounting or marketing encouraged many of the *nomenklatura* to stick with procedures and relationships they knew. Similarly, many enterprise officials uncomfortable with new responsibilities found ministerial intervention a benefit.

Over time, reforms promoting worker self-management also were reversed. The list of "critical sector" state enterprises in which workers' participation in management was legally restricted grew from 100 initially to over 2,000.

Results. Despite the initial flurry of legislation and attention to reform, over time it became clear to the *nomenklatura* that entrepreneurial incentive rarely was rewarded, nor was the costly hoarding of labor and materials often penalized. As a result, although Poland moved away from the traditional operating mode of centrally planned economies and direct bureaucratic controls, its indirect levers—tax and loan policies, market mechanisms, and the like—often failed to work properly, and in many cases they were ultimately supplemented or replaced by indirect bureaucratic controls.

By 1986 it had become clear that a reestablishment of central control over economic processes had taken place. The World Bank, however, notes that a number of significant changes did occur:

- The still-small private sector had been given legal status and was growing rapidly.
- Areas in the economy subject to direct commands had been reduced, though not nearly as much as intended.
- Use of market mechanisms had grown in scope and quantity.
- The economy had become marginally more open to foreign trade.
- Banking and credit system reforms led to at least partial distribution of investment capital through loans rather than grants.

1986-88: "The Second Stage" of Jaruzelski's Economic Reform

In 1986, General Jaruzelski revived plans to move ahead with the "second stage" of economic reforms. His motivations probably included the perception that living standards were declining and would eventually lead to unrest; that economic growth was slowing as Poland returned to production levels of the late 1970s; that Poland was falling further behind the West in living standards and in international competitiveness; that the West might soften its post-martial-law stance vis-a-vis Poland and again provide financial assistance if reforms proceeded; and, finally, that Gorbachev's program of *perestroyka* in the Soviet Union would help undercut the Polish hardliners who had opposed economic reforms on ideological grounds.

The second-stage reform consisted primarily of a restatement of unfulfilled first-stage objectives: enterprise self-management and self-funding; reduced party and central ministry influence; and greater reliance on market mechanisms. The second stage also sought to deal with emerging problems of a hybrid system and cited the need for:

- Tax reform.
- Breaking up large conglomerate enterprises to increase competition.
- Introducing more effective bankruptcy procedures to allow shutdowns of poorly performing enterprises.
- Imposing real interest rates to attract savings and put a real cost on borrowing.
- Phasing out subsidies on producer and consumer goods.
- Creating joint-stock companies.
- Restructuring the economy away from heavy industry to light industrial production, both to meet consumer needs and to develop new exports.

In mid-1987 the architect of Jaruzelski's reform, Deputy Premier Zdislaw Sadowski, presented a program and timetable for over 120 specific proposals and objectives. A national referendum apparently designed to give the reform the cachet of public support and to undercut reform opposition within the government backfired when worker cynicism over proposed price hikes led to a low turnout. The defeat of the referendum led to a government decision to raise prices incrementally over three years in an effort to reduce distortions and to create profit margins for enterprises that might spur increased production.

Workers responded to the first installment of price hikes in February 1988 with strikes and job actions which gave them wage increases well in excess of productivity gains and increased consumer prices. Most enterprises passed on increased labor costs by raising product prices, or they sought debt or tax relief. The increasing strains on the system aborted Sadowski's reform initiatives. As financial discipline broke down, accelerating inflation and another wave of strikes led to the resignation in September 1988 of the government of Premier Messner.

1988-89: Rakowski's Reform Efforts: Promising Beginnings . . .

Facing an increasingly aggressive labor force, the Rakowski government initially took a proreform stance and pledged to increase food supplies and accelerate housing construction. The government bolstered consumer goods supplies with immediate hard currency imports totaling $60 million, with another $240 million earmarked for equipment imports for consumer goods industries. Warsaw also raised farm procurement prices—retroactive several months—to placate farmers and stimulate agricultural production.

The Rakowski government also sought to promote private enterprise and foreign investment and to reform state-sector industry by breaking up large conglomerates. Ministerial appointments included reformers and proponents of private industry. New legislation sought to encourage more rapid growth in private enterprise by:

- Eliminating restrictions on the number of workers that could be employed.

- Lowering the basic tax rate on profits from 75 to 50 percent.
- Promising equal access to bank credits and material inputs.
- Streamlining registration procedures for new enterprises.
- Limiting central ministries' jurisdictions over private enterprise to matters of export restriction.

Legislation designed to encourage foreign investment also eliminated or reduced many restrictions on Western businessmen. In addition to having permission to establish joint ventures with either private or state-owned establishments, foreign firms can also set up fully owned subsidiaries.

Rakowski also enacted legislation that:
- Lowers the basic tax rate on profits to 40 percent from 50 percent, with tax rates on export earnings as low as 10 percent.
- Exempts enterprises with foreign participation from taxes during their first three years of operation.
- Grants joint ventures in priority areas an additional tax holiday of up to three years.
- Permits enterprises with foreign participation to repatriate up to 85 percent of their hard currency earnings (they must sell the remaining 15 percent to the Polish Government at the official exchange rate).
- Allows Polonia firms—small ventures headed by Polish expatriates—to convert to joint venture status to enjoy the more flexible provisions of the new law.

And Ultimate Failure

Despite promising beginnings, the Rakowski government faltered. Efforts to limit wage growth, budget deficits, and inflation were put off until an overall reform package could be drafted. But, the promised new program—"The Plan of Consolidation for 1989-1990"—never moved beyond the stage of deliberation. Efforts to control inflation and cope with a worsening economy remained on hold as political dialogue took precedence over economic policy.

It was at this point that the government more actively sought Solidarity's participation in economic policy making in hopes of increasing both public tolerance of needed austerity measures and trust in the government. These overtures led to the Roundtable talks in March 1989. Agreement was reached on political issues, but neither side was willing to press for economic reforms that would involve hardships likely to provoke unrest. The agreements that were reached—to cut the deficit, to reallocate budget spending, and to decontrol prices—were vague on timing and specifics. The most concrete agreement—to index worker wages to inflation—actually ran counter to the goals of reform. Political issues have continued to take precedence over economic questions, first in the runup to the elections, then in the maneuverings that preceded the nomination of Tadeusz Mazowiecki as prime minister, and finally in the bargaining that led to the formation of the new cabinet.

Lessons for the New Government

The new government under Mazowiecki has inherited an economy that is increasingly dysfunctional, operating in uncharted waters between central planning and market mechanisms. The history of repeated failures to reform the economy, however, provides clear indications of mistakes to avoid in the future. First, the Poles must break the cycle in which reform initiatives are undermined and circumvented by central ministries and state enterprises reluctant to adopt new patterns of economic behavior. Second, Polish reformers must do a better job of selling reforms to the public. Previous reform efforts have not followed through on meaningful profit, wage, or hard currency incentives for farmers, workers, or managers.

What Poland Needs To Do

The Mazowiecki government will have to consider steps to stabilize Poland's economy before attempting reforms, and recognize that some reforms will take longer than others to formulate and implement. Economic reform policy can be viewed in terms of Poland's immediate, midterm, and long-run needs.

Immediate Measures
An early stabilization of the economy is important, both to minimize unrest and to lay an effective foundation for future reform efforts. Controlling inflation, drastic budget cutbacks, and improvements in consumer supplies are of critical importance.

Inflation. The government will have to address accelerating inflation without delay. At this point, the chief source of inflation is uncontrolled government spending which stems from an explosion of subsidies on consumer and producer goods. Although decontrol of food prices probably will moderate the strain on the budget from consumer subsidies, the full impact of recently won wage concessions has not yet been felt. Before the end of 1989, increasing numbers of enterprises that have capitulated on wages probably not only will fail to deliver delinquent taxes, but will seek bailouts from the central budget just to meet their payrolls.

Warsaw has several options for slowing government spending. In order of increasing difficulty, they include:
- Sharp cutbacks or a complete freeze on budget outlays for investment and construction (except perhaps housing), as well as further reductions in defense spending.
- Reduction or elimination of central ministry functions and funding.
- Modification or elimination of wage indexation.
- A freeze or reductions in budget outlays for subsidies to both enterprises and consumers.

Sharply curtailing or ending state investment outlays from the state budget probably would be least difficult to accomplish, and would serve two additional important purposes in the short run. It would build on Poland's earlier reform efforts to shift investment funding from budget grants to bank loans. By first going after outlays that many view as squandered or mismanaged by the state, it also would help send the message to the public that the new government's reforms will be more than just another round of punitive price hikes.

Bolstering Consumer Supplies. The government must improve food supplies in order to minimize hoarding and panic buying. Many foods now seem to be in better supply but at much higher prices. Still, meat production in 1989 is expected to fall as much as 6 percent, and despite apparently good harvest prospects, some other shortages are likely. Warsaw will have to monitor market supplies; some hard currency food imports, in addition to scheduled Western aid, may be necessary.

Midterm Measures

After addressing its most visible problems, the government will have to move quickly to develop and promote an overall reform package. Financial reforms that improve operations of all sectors should be a priority, as should agricultural reforms to free private farmers from land sales restrictions and improve supplies of agricultural inputs. Encouragement of private enterprise and foreign investment can proceed on the basis of existing legislation. As Poland moves on these fronts, it will have to lay the groundwork for state-sector reform.

Financial Reforms. Financial reforms should be a priority, as they would facilitate other reforms elsewhere in the economy:
- The National Bank of Poland needs independence from political pressures to stabilize government spending.
- Interest rates must provide a "real" rate of return to attract savings and to place a real cost on borrowing.
- Banks must begin to evaluate loan applications in terms of risk and expected return.
- Loans must be made as available to private enterprise as they are to the state sector.
- Use of the undervalued official exchange rate should be abolished.

Encouragement of Private Enterprise and Foreign Investment. Private entrepreneurs and foreign investors would be reassured if the government quickly stated its support for reform legislation already in place. Continued growth in these areas might provide significant early boosts to Poland's export earnings and make a dent in some consumer goods shortages. The most valuable benefit of continued growth here, however, could be the impact on the state sector. New, larger private enterprises and joint ventures could provide an example to state industry of how reforms should work. Obvious successes could increase worker and management willingness to adopt market reforms in the state sector. Rapidly growing private and foreign sectors also could provide attractive new opportunities for employment and absorb workers from state industry who will be laid off when other money-losing enterprises are shut down.

Another way for the new government to increase opportunities for foreign investment would be the establishment of special trade zones—designated regions where joint ventures and foreign investors receive special tax breaks and other operating incentives. If they were located in coastal zones, they would serve to minimize the extent to which poor internal transport works against export and import deliveries. Special trade zones also would stimulate Poland to better focus investment outlays on modern infrastructure—telecommunications and utilities—and on financial and other service-sector support for joint ventures.

State-Sector Industry. Poland needs to focus on preparations for change in the state sector and to devise a consistent approach before going all-out in such areas as decontrolling prices, laying off workers, or shutting down unprofitable enterprises. Before letting markets determine prices and outputs, the ground rules must be in place and impediments to smooth market operations—barriers to entry, imperfect market knowledge, monopoly power of participants—need to be minimized in order to avoid inflation and shortages. The approach taken by the European Community to economic unification could be a useful model—setting a firm deadline for fundamental change and then proceeding methodically to put the pieces in place. As the EC's example demonstrates, this process can have a dramatic and positive effect on the public's mood and expectations.

Components of a comprehensive state reform package probably should include the following:

- The dismantling of central economic ministries.
- The revamping or replacement of the *nomenklatura* system to develop a managerial class responsive to market pressures.
- The codification of the rights of workers, management, and enterprises.
- The breakup of large state enterprises into smaller and more manageable ones.
- The creation of an unemployment compensation system.
- The development of a consistent set of regulations regarding bankruptcy legislation.
- The development of a functioning stock market.
- The stimulation of capital goods and intermediate goods markets.
- The creation of more realistic joint stock company procedures.

Agriculture. To expand farm production and modernize agriculture, Poland needs to liberalize conditions for land sales and to improve farmers' access to inputs by ending priority allocations to state farms. Land reforms that keep pension calculations independent of farmers' disposition of private landholdings are crucial to Poland's private farmers' abilities to consolidate small holdings and capitalize on economies of scale. The sizable amount of land abandoned by emigres must be made available for lease or sale. State farms could be allowed to go private or could be abolished, with land and assets auctioned off.

Price reforms, competition in manufacturing and marketing agricultural inputs, as well as in food processing and distribution, are necessary to increase farmers' profitability and productivity. The agricultural service sector holds great potential for expansion as farmers' earnings grow and allow for reinvestment.

Export Promotion. With the legalization of foreign exchange sales already in effect, Poland over time should increase the share of hard currency earnings kept by exporters—they should receive all of it, but perhaps pay tax in hard currency at an appropriate tax rate. Moreover, ending current restrictions on how exporters can dispose of their foreign exchange earnings could funnel hard currency to more effective uses. At present, firms earning hard currency must spend it themselves. The result is that they are encouraged to import goods available domestically, even as other firms needing imported materials and services have to do without.

Long-Run Perspective

In the long run, Poland needs to create conditions that channel funds and resources to profitable and efficient enterprises, even at the cost of permitting unprofitable ventures to collapse. This will mean a system of laws that guarantees the property rights of individuals and an economy open to the world. Once the prerequisite financial reforms are in place, Poland should move to full convertibility of the zloty to maintain internal and external equilibrium.

The Role of the West

Western assistance to Poland also can be viewed in terms of immediate, midterm, and long-run needs.

Immediate Needs

Poland needs help with food supplies over the next year, particularly meat. The major impact of this aid will be symbolic—a clear and tangible statement of Western support for Poland's new course. Food aid will have to be carefully administered, however, to make sure that Poland's food distribution system is not overwhelmed and to minimize any impact on market prices that might discourage farmers' plans for expansion of livestock herds. To help bolster livestock holdings over the long term, feed grains as well as meat are important.

Midterm Needs

Preparation for market reforms will require enhanced Polish awareness of how Western economies and businesses operate, and Western management training can make a crucial contribution. Western advice in setting up bankruptcy and unemployment legislation and in establishing codes to regulate stock markets and corporate financial practices will also be valuable.

Long-Run Needs

Poland would benefit from debt relief and renewed access to hard currency loans. For its part, the Polish Government must do what it can to repair the confidence of Western bankers and official lenders by putting reforms in place. Meanwhile, the formulation of concrete Western plans for debt assistance and rescheduling—to be carried out once Polish reforms are in place—would both encourage the Polish Government to proceed with reforms and help it gain public acceptance of reform.

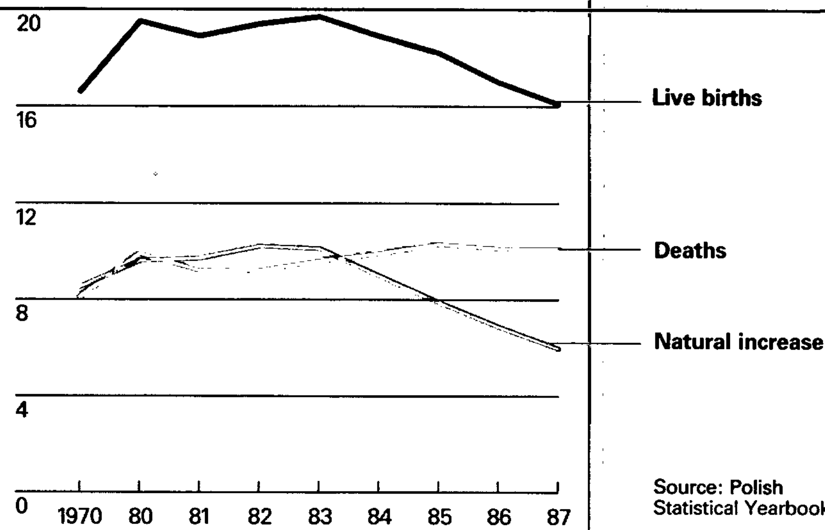
Perspective

Reforms in Poland have a difficult starting point. The foreign debt, inflation, and chronic shortages all work against effective reform policy. But, to the extent that the new government begins laying the groundwork for a long-run economic recovery, it will enhance prospects for public understanding and support. This could provide a much-needed "window of opportunity" to move forward with reforms. Overcoming or eliminating bureaucratic resistance to reform will remain the key difficulty. Communist-led governments also have been increasingly reform oriented, but policy differences within the party or central government have consistently scuttled or slowed the implementation of reforms. Dismantling state ministries and an overhaul of the *nomenklatura* system is thus crucial to the new government's hopes of revitalizing the state sector.

POLAND

4. Vital Population Statistics, 1970-87

Per thousand



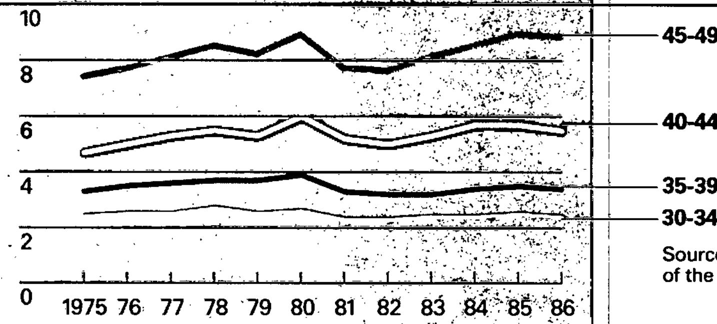
Source: Polish Statistical Yearbook

POLAND

5. Quality of Life Indicators

Male Death Rate by Age, 1975-86

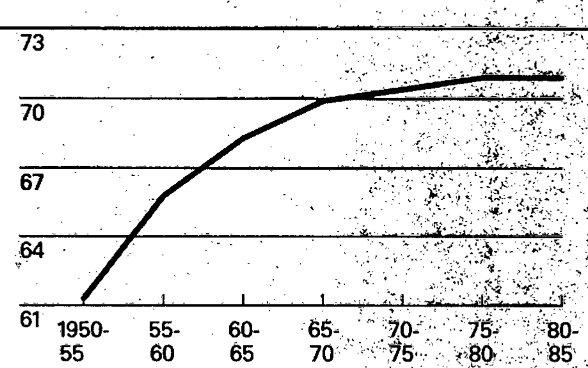
Deaths per thousand



Source: US Bureau of the Census

Life Expectancy, 1950-85

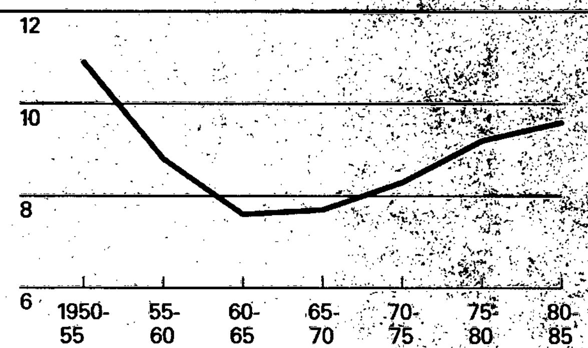
Years at birth



Source: US Bureau of the Census

Average Annual Crude Death Rate, 1950-85

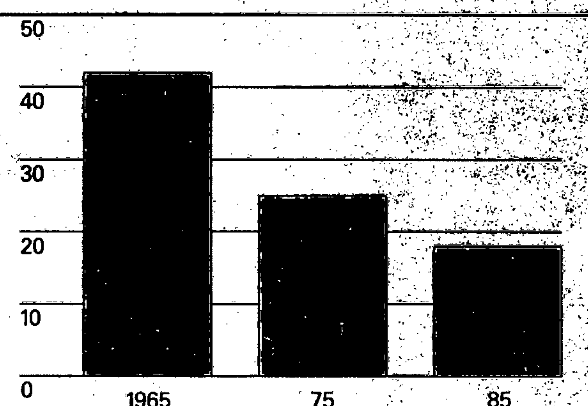
Deaths per thousand



Source: US Bureau of the Census

Infant Mortality, 1965-85

Deaths per thousand



Source: World Bank

United States Department of State

Hungarian Economic Reform: Status and Prospects

September 1989

United States Department of State

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Hungarian Economic Reform: Status and Prospects

Summary

Hungary has made genuine progress on some aspects of economic reform, but its financial position is becoming increasingly precarious because of backsliding on its much touted austerity and reform program for 1988-90, slow progress on reducing subsidies, and heavy spending by Hungarians taking advantage of relaxed travel rules. Although Budapest will not have to reschedule its foreign debt this year, a large current account deficit will add to its growing debt service burden and increase the already high risk of future debt servicing problems—problems that will pose additional challenges for the country's leadership as it tries to manage the difficult transition to a more democratic political system.

The economy's current troubles are not new. Economic problems beginning in the late 1970s have caused the Hungarian economy to struggle with sluggish growth, stagnant living standards, an increasingly obsolescent industrial base, and a rising foreign debt burden. These problems have their roots in the imposition of the Soviet economic model in the late 1940s—with inordinate emphasis on heavy industry—and the reorientation of a major share of Hungarian trade to the generally less demanding Soviet market. Meanwhile, the economy's adjustment to changes in world markets and to growing international competition has been slowed by macroeconomic policy errors, poor use of foreign loans, and inconsistent implementation of economic reforms.

To address the shortcomings of previous reform efforts and lay the basis for improved economic performance, the Hungarian Government has been trying to increase the role of market forces in the economy since late 1986. Over the past three years, it has legislated a broad range of measures to free the economy from administrative dictate, develop capital markets, and stimulate more efficient use of resources. These measures include reorganizing the banking system and introducing new financial instruments, creating a new tax system, expanding the scope of private and foreign investment, and establishing bankruptcy mechanisms. The government has also been moving gradually toward market-based wages and prices. Other ongoing reform efforts focus on better integrating the economy into world markets in order to expose Hungarian producers to greater competition and accelerate industrial restructuring. Last January, for example, the government took the first

steps toward a freer import regime, and it is currently evaluating the likely benefits and costs of placing trade with the Soviet Union on a hard currency basis.

Although these reforms go further than measures adopted elsewhere in Eastern Europe and are more comprehensive than any previous Hungarian efforts, they have had a limited impact on performance. Budapest continues to subsidize loss-making activities, fearing the social and economic dislocations associated with letting insolvent state enterprises fold. A relatively broad consensus on the need to accelerate the reform process appears to be forming among party reformers and many of the opposition parties. The leadership, however, will probably find it difficult to mount any major reform drive until after the multiparty parliamentary election scheduled to take place by June 1990.

In the meantime, the Hungarian Government has begun to look more toward Western governments to help put its economy on a sounder economic footing. The most significant contributions the West can make to Hungary's economic well-being are to provide technical and managerial expertise in a host of areas—including developing capital markets and a service infrastructure for the private sector, improving enterprise management, establishing foreign sales networks, and retraining large numbers of workers—and to encourage foreign investment in Hungary. Financial assistance can also help maintain reform momentum, but only if it is tied to specific projects or performance criteria to ensure that it is not used merely for financing consumption or for keeping ailing enterprises afloat.

Contents

Hungarian Economic Reform: Status and Prospects

Introduction

Pressed by a dismal economic performance in the first half of 1989, growing vulnerability to a debt rescheduling, and popular opposition to further austerity, the Hungarian Government has begun to look more toward Western governments to help put its economy on a sounder footing. To better understand where Western aid would be most effective in helping Hungary manage a relatively smooth and peaceful transition toward a more market-oriented economy and a more democratic political system, this paper will examine the nature and sources of Hungary's current economic problems. This background will lead to a summary of the progress made in various areas of reform that are vital to promoting greater productivity and a sustainable economic recovery. Finally, the paper will assess the prospects for further reform and look more specifically at what Western governments can do to nudge this process forward.

Growing Sense of Crisis

This year, backsliding on Hungary's much touted austerity and reform program for 1988-90, slow progress on phasing out subsidies, and heavy spending by Hungarians taking advantage of relaxed travel rules have made Hungary's financial position increasingly precarious and contributed to popular perceptions, prevalent since at least 1986, that the economy is in crisis. The leadership has been reluctant to take measures that could lower the standard of living or create unemployment because it must compete sometime before next June in Hungary's first free parliamentary election since 1948. Thus, efforts to shift resources from established, but ailing, industries—in particular, steel and coal mining—to newer, more competitive firms have continued to proceed slowly, and industrial growth faltered in the first half of the year, falling 0.7 percent. At midyear, the budget deficit, money supply, and current account deficit had all exceeded targets established in conjunction with the International Monetary Fund (IMF), while Hungary's foreign exchange reserves dropped to an uncomfortably low level of less than three months' worth of imports. Inflation—at 18 percent—was also higher than planned, but household incomes kept pace, rising about 2 percent in real terms as compared with a planned decline under the austerity program.

Despite these worsening indicators, Hungary has not had any serious difficulties raising needed credits in international capital markets and probably will avoid debt servicing problems this year—even if it fails to reduce the current account deficit from its current level of nearly $1 billion to a revised target of $600 million. Financing a larger-than-planned deficit, however, will add to Hungary's future debt service burden and increase its vulnerability to a debt rescheduling. Hungary is already at great risk of future debt servicing problems because of sharply rising debt service costs in the early 1990s and the low export competitiveness of its economy.

If at any time commercial bankers lose confidence in Budapest's economic management and cut short-term credit lines—as they did in 1982—Hungary would probably have to reschedule its foreign debt within a few months. Budapest usually carries at least $2 billion in short-term debt to finance trade and other transactions; without this funding, hard currency reserves—now just $1.2 billion—would be quickly depleted. The possibility of a rescheduling would increase significantly if climbing interest rates raised debt service costs and caused a recession in the West that reduced demand for Hungarian exports. It would also increase if world prices for some of Hungary's key hard currency exports, including aluminum, agricultural commodities, and petroleum-based products, softened.

A rescheduling probably would temporarily set back Hungary's reform efforts, unless Western governments and international financial institutions guaranteed a continued flow of new credit. Without such assistance, Budapest's ability to borrow on commercial money markets would be limited, requiring a severe reduction in imports as well as tougher austerity measures. As a result, Budapest would be more cautious initially about implementing major reforms, such as currency convertibility, that could lead to a short-term deterioration in its external accounts. Also, the government probably would suspend previous measures, such as the removal of administrative controls on imports and liberalized access to hard currency for private citizens. Because most of the leadership recognizes the need for a more market-based economy, however, a rescheduling probably would not erode Budapest's commitment to reform in the longer term.

Sources of Hungary's Economic Woes

The economy's current troubles are not new. Since the late 1970s, the Hungarian economy has struggled with sluggish growth, stagnant living standards, an increasingly obsolescent and uncompetitive industrial base, and a rising foreign debt burden. These problems stem in large part from deep-seated structural problems:

- Overemphasis on heavy industry and energy. Heavily subsidized industries—mining and ferrous metallurgy are prime examples—are a serious drain on the budget. Moreover, productivity growth in most manufacturing branches is below international norms, limiting Hungary's export potential and ability to service its foreign debt.

- Weaknesses in the agricultural sector. Even agriculture, long considered Hungary's success story, has accrued mounting losses in the face of reduced subsidies and input costs that are rising faster than final sales prices.

- The high degree of monopolization and unnecessary vertical integration. Too many large monopolistic enterprises are protected from competition and bankruptcy by vested interests in the party and government bureaucracies. In addition, many components are inefficiently produced within enterprises because factory managers seek to be as self-sufficient as possible and because there are few small and medium-sized supplier industries that produce common components in bulk.

- A neglected infrastructure. The deficiencies of the telecommunications system in particular make it difficult to conduct business on a timely basis.

- Low technological development. Reliance on centralized R & D institutes and a tendency to focus more on fundamental than applied research have slowed both product development and the assimilation of foreign technologies.

Recent Hungarian Government studies attribute the economy's problems to the imposition of the Soviet economic model in the late 1940s and reorientation of a major share of Hungarian trade to the generally less demanding Soviet market. While these factors as well as unfavorable external developments undoubtedly have played an important role, macroeconomic policy errors, poor use of foreign loans, and inconsistent implementation of economic reforms have slowed the economy's adjustment to changes in world market demand and prices and to growing international competition.

Macroeconomic Policy Errors

Hungary is again on the verge of financial crisis in part because of the legacy of misguided efforts to grapple with its persistent balance-of-payments problems. Reliance on administrative measures, such as import and investment controls, to cope with these problems in the first half of the 1980s appeared prudent initially because high rates of investment in the 1970s had inflated demand for Western imports, leading to trade imbalances and a sharp rise in foreign borrowing. The 20-percent cumulative decline of investment between 1979 and 1985, however, held back the establishment of new ventures and the modernization of potentially dynamic enterprises. As a result, the average age of manufactured product designs is now about 16 years, while the share of designs under three years old is less than 15 percent, according to the Hungarian Chamber of Commerce. Modernization efforts were further hindered by the fact that the share of investment in the energy and basic materials sectors rose from 14.7 percent in 1976-80 to 17.9 percent in 1981-85, while the share of manufacturing declined from 20.9 percent to 16.3 percent. The resulting limited change in the sectoral shares of industrial output, employment, and capital stock since 1975 illustrates the lack of structural adjustment (see table 1).

Table 1
Hungary: Branch Structure of Industry

Percent share

	Output		Employment		Fixed Assets	
	1975	1987	1975	1987	1975	1987
Total heavy industry	67.8	69.6	58.6	60.6	75.4	77.2
Mining	9.2	6.9	7.2	7.7	9.0	10.8
Electric energy	5.1	6.0	2.2	2.9	15.2	19.9
Metallurgy	10.0	8.0	6.0	5.7	10.8	9.0
Engineering	24.0	25.9	31.6	32.3	17.6	17.0
Machinery	6.1	5.8	8.7	8.5	4.0	3.8
Vehicles	6.9	7.1	6.2	6.4	5.6	5.0
Electrical engineering	3.1	3.3	3.4	3.8	2.1	2.0
Telecommunications	2.7	4.7	5.6	6.5	2.6	3.0
Precision engineering	1.7	2.5	3.3	3.6	1.3	1.5
Metal products	3.4	2.4	4.4	3.5	2.0	1.6
Building materials	3.2	3.3	4.8	4.5	6.9	5.3
Chemicals	16.3	19.5	6.8	7.5	15.9	15.2
Light industry	14.4	12.9	26.4	22.7	12.2	9.9
Miscellaneous	1.0	0.9	3.6	2.5	1.1	0.6
Food	16.8	16.6	11.4	14.2	11.3	12.3

Source: Hungarian Statistical Yearbook.

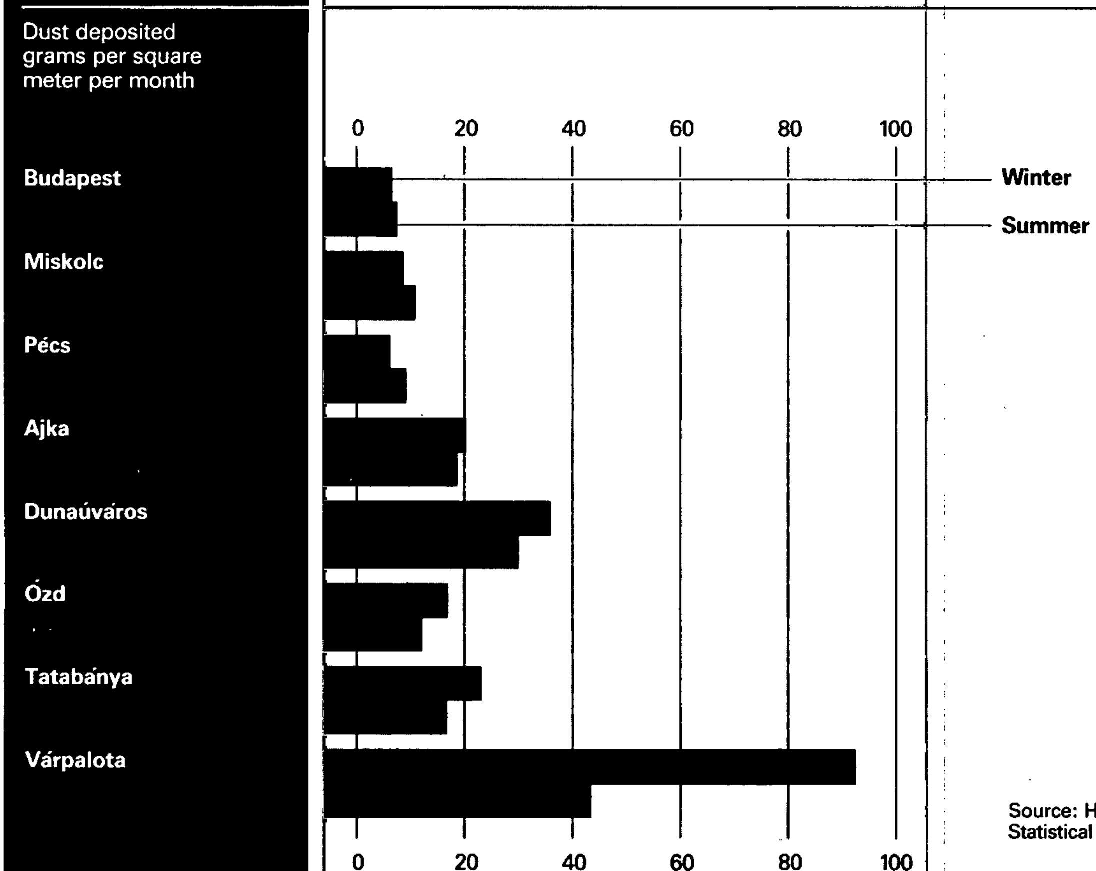
Substantial investment in energy production, moreover, has neither increased output—with the exception of nuclear power, which still accounted for less than 15 percent of domestic energy production in 1987—nor improved efficiency significantly. Investment in oil, coal, and gas production has had limited payoff because of the small size of reserves, complex geological conditions, a shortage of hard currency to acquire modern technology for deep drilling, and Western restrictions on the export of advanced technology. Hungarian planners expect only a slight increase in natural gas extraction and the leveling off of petroleum and coal output in the next decade.

Policymakers have tried to encourage conservation with preferential loan programs, but growth in energy productivity has slowed since 1982, and efforts to conserve energy have been less effective than in the West. Easy conservation gains may have been exhausted in the early 1980s, and energy productivity has probably suffered from the increasing obsolescence of Hungary's industrial base. Greater conservation savings as well as lower air pollution levels could have been achieved if more investment had gone toward modernizing production facilities and restructuring the economy away from energy intensive sectors, such as metallurgy, and if policymakers had stopped subsidizing household energy prices (see figure 1).

The restrictions on investment and imports, nonetheless, produced sizable current account surpluses in 1983-84, which helped Hungary regain access to commercial credit after near bankruptcy in 1982. Hungarian policymakers concluded they had weathered their financial problems and could shift priorities back to economic growth. Thus, Budapest loosened controls on domestic credit, government spending, and imports. But, because export industries were uncompetitive and agriculture was adversely affected by several years of poor weather, economic performance fell far short of plan and payments imbalances reemerged. GNP growth averaged only 0.1 percent annually in 1985-87, while higher-than-planned growth in

HUNGARY

1. Air Pollution in Selected Cities, 1986/87



Source: Hungarian Statistical Yearbook

investment and consumption—coupled with pent-up demand for Western capital and consumer goods—led to a surge in hard currency imports and the reemergence of large current account deficits (see figure 2).

The hard currency trade balance swung from a $1.2 billion surplus in 1984 to a $540 million deficit in 1986 and, along with rising interest charges on debt, pushed the current account deficit to a record $1.4 billion. In 1987 and 1988, austerity policies, coupled with an export drive and an upswing in world prices for Hungary's metallurgical and agricultural exports, helped narrow the deficit, but the improvement was less than the government was aiming for (see figure 3). Financing these large deficits, in turn, hiked Hungary's hard currency foreign debt from $8.8 billion in 1984 to its current level of about $17 billion.

Poor Debt Management

Hungary is extremely vulnerable to a debt rescheduling because the leadership has allowed its foreign debt to rise much too rapidly in comparison with the economy's capacity to repay the loans; much of the borrowing went to shield consumers from austerity and industry from painful restructuring. As a result, Hungary now has the highest per capita debt in Eastern Europe and is devoting a greater share of its hard currency earnings to debt service than any other East Bloc country. Hungarian Trade Ministry officials estimate that Hungary's future financing needs—debt principal repayments and net interest payments—will amount to $11.1 billion over the 1990-92 period, $8-9 billion of which they expect will need to be covered by loans from the World Bank, the IMF, and commercial banks.

Because it has given top priority to servicing its debt, Hungary has better access to commercial credits than does Poland and each year is able to roll over most of its maturing principal. Nonetheless, debt service costs probably will exceed 40 percent of hard currency goods and service earnings through at least 1992. Such high obligations severely limit resources for investment and have led the leadership to push exports to the West, even at the cost of subsidizing unprofitable exporters.

Shortcomings of the Reform Process

The Hungarian economy is not performing up to the high expectations created by its reform efforts. The watering down of successive initiatives and insufficient understanding of how a market economy functions have left some of the fundamental flaws of central planning largely intact and failed to create adequate incentives for promoting industrial restructuring. Reforms have focused mainly on decentralizing decisionmaking in state enterprises and only selectively on injecting market forces into the economy. In the first half of the 1980s, Budapest broke up some large enterprises into smaller units, merged ministries responsible for specific industries into a single Ministry of Industry, and introduced various other measures, including a type of worker self-management, to increase enterprise autonomy. In addition, it allowed private and cooperative ventures gradually to expand the scope of their activities. The leadership, however, never intended to go further than merely improving the functioning of its centrally planned economy and, until recently, did not recognize the need to develop true capital and labor markets to promote greater efficiency.

In the absence of genuine markets, the authorities have moved from setting plan targets to creating a set of frequently modified "regulators"—including subsidies, wage and price rules, and taxes—designed to simulate the workings of a market. The same bargaining between enterprises and the state that had occurred over plan targets has continued over the regulators, undermining their effectiveness. In addition, tax breaks and subsidies to ailing enterprises, which the leadership has not had the political will to close, have conflicted with efforts to promote profit-mindedness among managers and more efficient resource allocation. Moreover, the bureaucracy's constant tinkering with reform and its attempts to make the system work with a plethora of enterprise-specific regulations and exemptions have created an atmosphere of uncertainty for enterprise managers, leading them to spend surplus funds quickly and to develop a short-term horizon for planning and investment decisions.

Renewed Emphasis on Reform

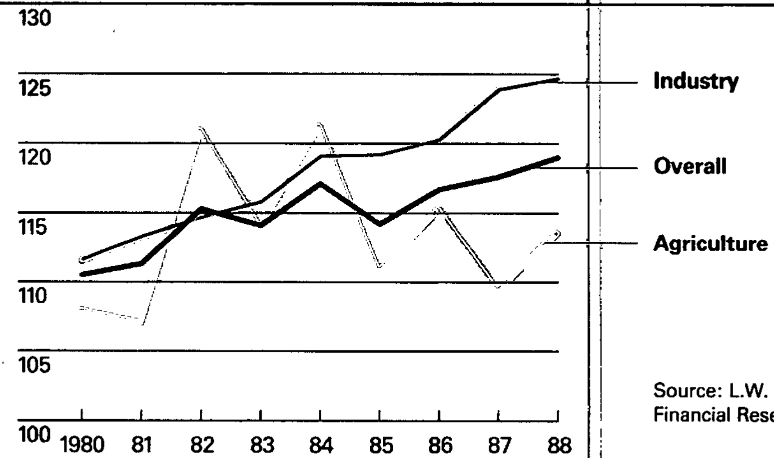
To address the shortcomings of previous reform efforts and lay the basis for improved economic performance, the Hungarian Government has been trying to increase market forces in the economy since late 1986. Over the past three years, it has legislated a wide range of measures to free the economy from administrative dictate and to develop capital

HUNGARY

2. Selected Growth Indicators

Selected GNP Indices, 1980-88

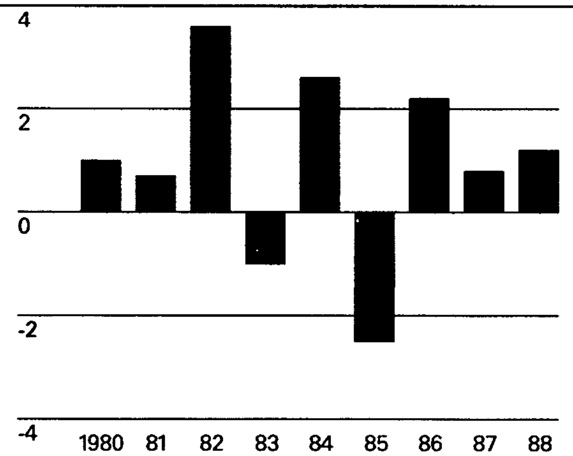
Index: 1975=100



Source: L.W. International Financial Research, Inc.

Real GNP Growth, 1980-88

Percent



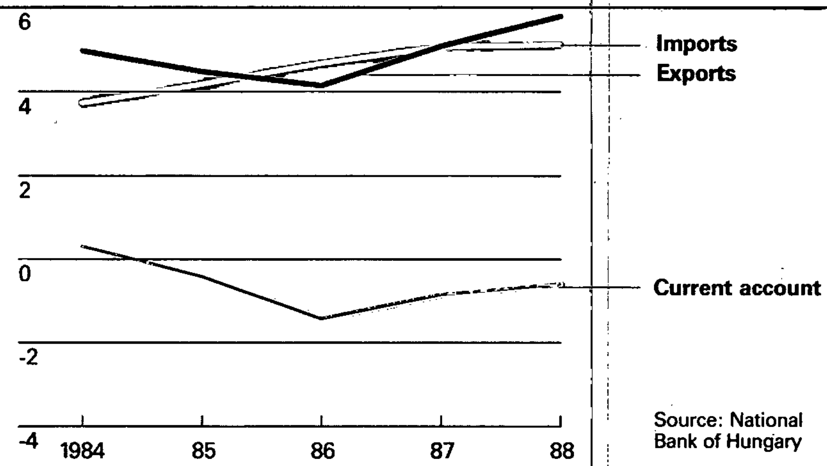
Source: L.W. International Financial Research, Inc.

HUNGARY

3. Selected External Financial Indicators

Hard Currency External Accounts, 1980-88

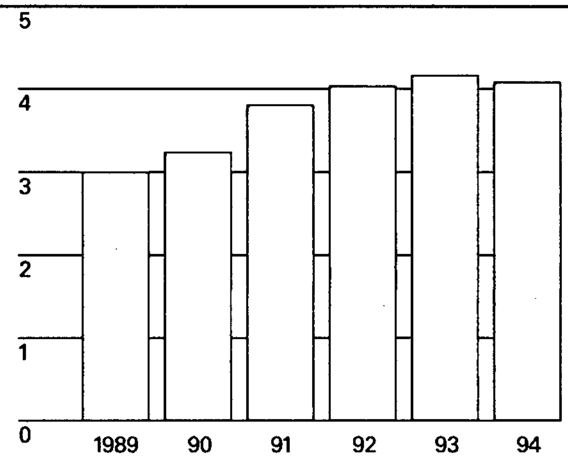
Billion US $



Source: National Bank of Hungary

Hard Currency Debt Service[a], 1989-94

Billion US $



[a] Principal and interest

markets capable of stimulating more efficient use of resources and easing capital constraints on growth. These measures include reorganizing the banking system and introducing new financial instruments, creating a new tax system, expanding the scope of private and foreign investment, and establishing bankruptcy procedures. The leadership also has taken steps toward market-based wages and prices, but is moving slowly in these areas because domestic competition is still weak. Because many reform measures are either still being phased in or have not been implemented as planned, a brief summary of their progress will help clarify the current obstacles to change and the areas in which Western assistance would have the greatest impact in furthering the reform process.

Financial Sector

Since the government reorganized the banking system in January 1987—establishing a two-tier banking system composed of a central bank and independent, competing commercial banks—commercial banks have gradually gained greater autonomy. At the same time, commercial bank activity is limited by a shortage of trained personnel and by the austerity program and its accompanying tight monetary policy.

This year, additional steps have been taken to increase competition between banks. For example, restrictions on the deposit taking and credit activities of the banks have been eliminated. Commercial banks are now permitted to accept deposits from and to lend to individuals, while the National Savings Bank and savings cooperatives may offer banking services to enterprises. The National Bank still maintains a monopoly over foreign exchange transactions, but it may give it up in 1990.

Budapest has also encouraged the founding of other financial institutions, including joint Hungarian-foreign banks, which have carved out a niche servicing joint ventures and foreign companies participating in World Bank projects. It has also introduced new financial instruments, such as bonds and stocks. Bonds have been in use since 1983, but the securities market is still in its infancy, functioning more like a small trading club than a stock exchange.

Hungary probably will continue gradually to liberalize its financial markets, but the process will have a limited impact on capital flows in the near term because:

- The state still heavily influences investment decisions by controlling a significant share of enterprise income through taxes and subsidies.

- The new banks' ability to extend loans is limited because of their small capital base, large reserve requirements, and the high refinancing rate charged by the National Bank. Because of Hungary's weak balance-of-payments position and the need to dampen domestic demand and imports, Hungarian officials appear determined to keep tight control on commercial banks to avoid an inflationary credit surge. Financing the state budget deficit also claims a sizable share of the financial sector's resources.

- A shortage of skilled bank managers and inadequate telecommunications and computer networks hinder the expansion of banking operations. Banks also need to improve their internal accounting and auditing procedures and to develop means of evaluating investment projects and enterprise creditworthiness. This is difficult because, in an economy with an extensive subsidy system, a limited number of market-determined prices, and a nonconvertible currency, profits often fail to reflect the most efficient use of resources. In addition, most enterprises do not have adequate bookkeeping.

- The new banks have been saddled with many financially troubled customers who tie up their lendable resources, but they do not have adequate loan loss reserves to force these clients into bankruptcy and are likely to encounter resistance from elements of the political leadership if they try to do so. Hungarian economists are concerned that continued state support of insolvent companies and tight monetary policies are serving merely to preserve the existing industrial structure.

Subsidies, Taxation, and Budget Reform

Heavy subsidization of industry, agriculture, and consumer prices, which in turn necessitates excessive taxation, is at the heart of the economy's structural problems. State subsidization of Hungarian enterprises has accounted for about a quarter of budget expenditures throughout the 1980s and represents the equivalent of about 20 percent of gross domestic product (GDP). This system has had a devastating impact on economic performance by supporting loss-making enterprises and penalizing successful companies (see inset and table 2).

In 1988, Hungary introduced a tax reform in an effort to increase financial discipline and reduce the role of the central government budget in financial intermediation. The changeover from a complex system of turnover and other taxes to a value-added tax and personal income tax was intended to end the discriminatory tax treatment of private enterprises and reduce an extremely high corporate tax rate both by broadening the tax base and by shifting taxation from production to consumption.

Thus far, the tax reform has fallen short of these objectives. Enterprises have ended up shouldering most of the burden of personal income taxes, as they were required to compensate employees for the new taxes they had to pay. Although the profit tax rate now has been reduced to 54 percent, the state still claims the bulk of enterprise profits through various other assessments. Raba, a manufacturer of truck axles and one of Hungary's top exporters to the West, has complained publicly about the unreasonably large share of company profits—about 80 percent—that continues to be siphoned off by the government.

In contrast, the personal income tax is a relatively small proportion—some 12 percent—of the population's earnings from wages, interest, and dividends because of a wide range of exemptions and allowances. Personal tax rates are sharply progressive, however. The top tax rate has been lowered from 60 percent in 1988 to 52 percent in 1989, but it almost certainly has an adverse effect on personal initiative.

Recognizing the need to further reduce corporate taxation and state involvement in the economy, the government has called for reform of the budget. Minister of Finance Laszlo Bekesi has said the fundamental goal should be to reduce the budgetary redistribution of incomes from the current 60 percent of GDP to 40 to 45 percent by 1992. Subsidies, for example, would be slashed from their current level of over 200 billion forints to about 100 billion forints—a significant reduction, especially if the annual inflation rate remains above 15 percent. Even with lower subsidies, such a major cut in budgetary expenditures will be difficult, given the pressing need to modernize Hungary's infrastructure and the growing demands for a better social welfare net.

Subsidies

Subsidies have accounted for between 26 and 29 percent of state budget expenditures in recent years. Such support is extended by various means, including investment grants, the writeoff of tax and debt liabilities, and direct and indirect subsidies, of which there are least five different types:

- *Consumer subsidies are paid mainly on basic goods including some foods, energy, medicines, utilities, and transport.*

- *CEMA price equalization subsidies are granted to enterprises in order to make it profitable for them to fulfill state agreements with the CEMA countries. Metallurgy and food processing are the main beneficiaries of this support.*

- *Producer price subsidies are provided mainly when producer prices do not cover actual costs because of price setting by the government. The subsidy is determined by the relationship between the administered price and the production cost of a given commodity, irrespective of the profitability of production.*

- *Agricultural policy supports fall into two major categories: general production subsidies, including subsidies for milk production and the raising of cattle, sheep, and goats, and subsidies to farms in agriculturally disadvantaged areas.*

- *Import subsidies apply to a few basic commodities, mainly energy products, whose domestic prices are administratively fixed at a lower level than the actual import price.*

Table 2
Hungary: Central Government Subsidies, 1983-88

Billion forints
(except where noted)

	1983	1984	1985	1986	1987	1988
Total	**164.4**	**159.9**	**169.3**	**201.5**	**217.4**	**215.3**
Producer subsidies	97.8	106.4	119.1	141.7	150.7	156.3
Consumer price subsidies	66.6	53.5	50.2	59.8	66.7	59.0
Share of budget expenditures (*percent*)	28.9	26.1	26.2	27.7	27.3	25.0 [a]

Sources: Hungarian Statistical Yearbooks, East European Markets. [a] Estimate.

Ownership and Privatization

Although many legal restrictions on private enterprise have been lifted, and entrepreneurship is acknowledged as a key element for economic recovery, privatization efforts and Hungarian entrepreneurs still face many obstacles. The key problems include heavy taxation and bureaucratic redtape, limited access to commercial loans and hard currency, an uncertain investment climate, and an inadequate infrastructure, particularly the availability of office space, telephones, and computers.

Since Budapest began legalizing an ever-widening range of private-sector activities in 1982, this sector has been the most vibrant part of the economy, outperforming the state sector in job creation, output growth, and productivity. It has helped Hungary avoid a severe decline in economic growth and has improved the supply of many consumer goods and services. Recent studies of the private sector by Hungarian and Western researchers show that:

- The private sector, including production from private agricultural plots, accounted for 14.3 percent of GDP in 1988, according to official Hungarian figures. Furthermore, unreported economic activity may equal as much as 15 percent of official GDP.

- Three out of four working Hungarians participate at least part time in the private sector, and the work force devotes about one-third of its total worktime to private activities.

- Approximately 2,000 small-scale cooperatives, each with fewer than 100 employees, essentially function as private enterprises. Many are small industrial or service operations associated with large agricultural cooperatives or state farms.

- Agriculture is the largest private-sector employer, and private producers are the primary suppliers of such key food items as pork, eggs, potatoes, vegetables, and fruit.

- The private sector accounts for about 95 percent of housing construction and some 60 percent of consumer services, such as restaurants, automotive repair work, and beauty shops.

- The private retail sector, with close to 60,000 employees and about 40,000 outlets, accounts for 15 to 20 percent of all retail sales.

The private sector received a significant boost last January with the introduction of a new enterprise law that goes well beyond other comparable legislation in Eastern Europe in three broad areas:

- Expanding opportunities for private investors by allowing Western ownership forms, including limited liability and joint stock companies, and employment of up to 500 workers.
- Reducing discrimination against the private sector with a more uniform corporate tax system.
- Liberalizing foreign investment by permitting wholly foreign-owned ventures.

The National Assembly passed additional legislation in May 1989 governing the conversion of state enterprises to joint stock companies. Such companies now have the right to sell shares—even majority shareholdings—to Hungarian citizens and companies as well as to foreign investors.

Hungary has also passed the most liberal joint-venture laws in the East Bloc in order to encourage foreign investment and gain access to the Western capital, managerial expertise, and technology needed to modernize its economy. To attract investors, joint ventures in priority sectors—including chemicals, automotive components, metallurgy, and food processing and packaging—are exempt from taxes for five years.

The tax breaks and more liberal political climate have encouraged an increasing number of foreigners to establish joint ventures. By the end of 1988, there were 288 such ventures, with $320 million in paid-in capital, more than any other East European country has attracted. Budapest claims an additional 300 ventures have been formed so far this year, but it is unclear how many of these will actually get off the ground. Hungary is even having some success attracting foreign companies to invest in its troubled enterprises. In August 1989, for example, two West German steel companies took over a 60-percent share of an ailing steel mill with a capital injection of 30 million deutsche marks ($15.2 million), according to Hungarian press reports. In fact, Hungarian officials claim foreigners invested $17.8 million in metallurgical ventures through the end of June and have signed letters of intent on projects amounting to another $120 million. They estimate at least $1 billion would be needed, however, to bring this sector up to Western technological standards.

To encourage an even larger inflow of funds, Hungary recently liberalized its property laws. As of last July, joint ventures, limited companies, and public limited companies in which foreigners hold shares may buy real estate without any restrictions, even if Hungarian ownership is no more than 1 percent. Wholly foreign-owned companies may also purchase real estate, but only with a government permit.

Despite the dramatic rolling back of legal restrictions on the private sector, private ownership of industrial assets probably will not expand rapidly. The conversion of state enterprises to joint stock companies will be difficult because many important issues, such as how to value enterprise assets for creating shares, remain unresolved. There are numerous other obstacles as well. These include:

- An unfavorable climate for private investment in stocks and bonds. Hungary's fledgling bond and stock markets have had trouble attracting private investors, mainly because they are unable to offer dividends high enough to compete with rising inflation and the interest rates offered on bank deposits. Double-digit inflation and lack of confidence in the government's management of the economy are also encouraging consumer spending at the expense of personal saving and investment.

- Continuing state control of joint stock companies. The conversion law provides only for a minimum 20-percent state ownership in state companies that have become joint stock companies. The bulk of shares, however, will be retained by state and quasi-state organizations, such as the social security fund, municipalities, and insurance companies, because there are few other potential owners possessing the necessary capital. Such shareholders may not have the same overriding interest in enterprise profits as private shareholders and will be more amenable to government influence than private investors.

- Checks on private ventures. Private entrepreneurs—and state enterprises as well—must contend with excessive bureaucratic redtape and a still onerous tax burden that limits the resources available for expansion. Private businesses have much more limited access to commercial loans and hard currency for imports of Western capital goods than state companies and lack the "subsidy safety net" provided to state enterprises and large cooperatives. Occasionally, even when they do have access to funds, they find the terms too stringent. The National Association of Private Entrepreneurs has complained, for example, that a World Bank loan for private enterprise is attracting few borrowers because the 22-percent interest rate set by the National Bank, which is administering the loan, is too high. In addition, Hungary does not have an adequate support network of accountants, lawyers, bankers, and other professionals experienced in providing services and training to small businesses.

Despite these obstacles, private and joint ventures are certain to contribute increasingly to national and personal income growth, not least because the entrepreneurial drive is still alive in Hungary. Foreign investment and privatization of state companies, however, are not—as many in the Hungarian leadership appear to believe—fast-acting cure-alls for the economy's deep-seated structural problems.

They cannot produce significant economywide restructuring in the near term because of continuing state control over most large companies and because of the long leadtime needed to negotiate and set up joint ventures with foreign partners.

Bankruptcy

About 170 bankruptcy proceedings have occurred since the Hungarian parliament approved bankruptcy legislation in September 1986, but almost all have involved small cooperatives or private firms. Major state companies are still largely immune from the bankruptcy threat because the leadership fears that massive layoffs will precipitate a wave of labor unrest and that closing down some of Hungary's biggest loss-makers could cause shortfalls in the supply of certain goods for domestic consumption as well as for export. These fears are not unreasonable; in 1986, the five enterprises with the largest losses accounted for nearly 10 percent of industrial output, according to a Hungarian press report.

Budapest thus continues to bail out troubled state companies instead of liquidating them. Successful bailouts are rare, however, and a number of firms—the Ganz-Mavag transportation equipment company is an example—have been rescued three or more times over the past decade. Poor results are due in part to the fact that the management of these firms is seldom replaced, sometimes because of personal influence, but also because of a shortage of qualified personnel. Moreover, government authorities often fail to follow up to assure that rescued firms are making a concerted effort to restructure their operations.

The extent to which the government will accelerate restructuring and force more bankruptcies over the next several years depends on the leadership's ability to ease social tensions by both stimulating new plants and employment in areas where smokestack industries are concentrated and providing adequate unemployment benefits. The government currently has only limited funds for unemployment insurance, retraining programs, and investment promotion as well as public works projects and other job creation schemes in depressed regions. Out of 20,000 unemployed—less than 0.5 percent of the work force—in May 1989, only about 3,000 were receiving unemployment assistance, which requires at least 18 months' employment in the state sector during the preceding three years. The expense of a more comprehensive program could be substantial. Hungarian officials estimate 150,000 to 200,000 people would be thrown out of work if restructuring efforts were vigorously pursued, a reasonable estimate if, as Finance Minister Bekesi claims, Hungarian factories employ about 20 percent more workers than they actually need.

Wages and Labor Productivity

Budapest faces a dilemma in trying to reform wages. On the one hand, it wishes to avoid wage push inflation; on the other hand, it wants to encourage individual initiative, improve productivity, and move away from providing basic necessities such as housing, food, heat, and transportation at heavily subsidized prices. Since January 1989, enterprises have been free to determine individual earnings subject to a performance-related ceiling on their total wage bill—a system that still allows a modicum of central control until market forces are strong enough to discourage enterprises from granting excessive wage increases. The parameters of wage policy are set through a collective bargaining process that involves representatives of the official trade union, the Chamber of Commerce, private business, cooperatives, and the government. Wage increases above recommended levels are subject to prohibitory taxes, thereby effectively limiting the scope for wage differentiation. The leadership has, however, been gradually reducing such tax penalties as well as granting greater wage-setting freedom to firms that meet certain performance criteria.

Meanwhile, most firms have had few incentives to use labor efficiently because of the limited differentiation of wages and artificially low overall labor costs. Workers have also lacked incentives for greater effort on their state jobs because declining real wages have forced nearly three-fourths of the work force to seek part-time employment in the private sector, where wages are not controlled, to maintain their standard of living. Widening income differentials between state and private jobs have aggravated social tension and hurt productivity in the state sector. The personal income tax introduced in 1988 was intended to narrow these differentials, but tax evasion is probably common. Hungary's precarious financial situation probably

Table 3
Hungary: Annual Real Wage, Income, and Consumption Growth

Percent change over previous year

	1981	1982	1983	1984	1985	1986	1987	1988 [a]
Real wage per earner	1.1	−0.7	−3.2	−2.4	1.3	1.9	−0.4	−6.5
Real income per capita	2.9	0.9	1.1	1.1	1.9	2.3	0.7	−2.0
Per capita consumption	2.6	1.3	0.7	1.4	1.5	2.2	3.9	−4.2
Consumer price index	4.6	6.8	7.4	8.2	6.9	5.4	8.5	15.7

Sources: Hungarian Statistical Yearbook, National Bank of Hungary Quarterly Review.

[a] Preliminary.

will require future cuts in real wages and consumption, which will make it even more difficult for enterprise managers to command stricter labor discipline and higher productivity (see table 3 and figure 4).

Inadequate funds and mechanisms for retraining and relocating large numbers of workers have further slowed efforts to boost labor productivity and to restructure industry. In 1989, about 72 percent of job applicants were unskilled laborers or semiskilled workers, whereas 89 percent of the reported vacancies called for special skills. Hungarian state industry is unable to fill vacancies for skilled labor because many workers with advanced technical training can earn more in private-sector pursuits such as cab driving. According to Hungary's National Technical Development Board, every third technical university graduate earns a living in a nonrelated profession. Workers' attachment to their places of residence and serious housing shortages have been additional obstacles to labor mobility. To encourage more mobility, policymakers must eventually allow greater wage differentiation, raise wage levels in the state sector, expand retraining programs, and improve the housing supply. Housing construction may slow, however, because the government has had to terminate its heavily subsidized housing loan program because of budgetary pressures and financial reforms.

Productivity increases probably are also being hampered by the population's declining health. The deteriorating economic situation, which has forced more people to work longer hours to make ends meet, and crowded living conditions have taken their toll. Statistics show increasing incidences of heart disease and alcoholism as well as a significant rise in the mortality rate of men between the ages of 30 and 49. Moreover, the decline in the health of the population has not been matched by a corresponding improvement in state health services. Thus, the cost to the economy of absenteeism and lengthy illnesses is likely to rise in coming years (see figure 5).

Gradually Moving Toward Market Pricing

Although Hungary has significantly reduced direct administrative controls over prices, it still has a long way to go until market supply and demand are the preeminent factors in price determination. In the absence of a competitive goods market, most of Hungary's many price reform efforts over the past 20 years have focused on trying to simulate how market-determined pricing would work. In practice, the various price mechanisms quickly grew too complicated and contributed little to cost sensitivity. Only in recent years have Hungarian policymakers attempted to establish appropriate wholesale prices relative to retail prices and to end the subsidization and administrative setting of consumer prices along with other reforms designed to increase competition.

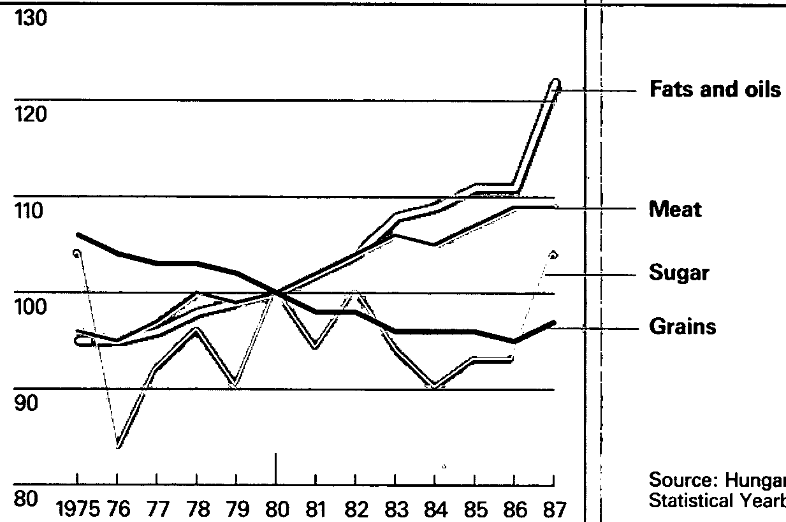
Consumer goods currently are subject to four types of pricing regulation:

- Administered prices. These cover the 17 percent of consumer goods that are subsidized, including household energy, transportation, milk, some basic food items, and pharmaceuticals.

HUNGARY

4. Per Capita Consumption Indices, 1975-87

Index: 1980=100



Source: Hungarian Statistical Yearbook

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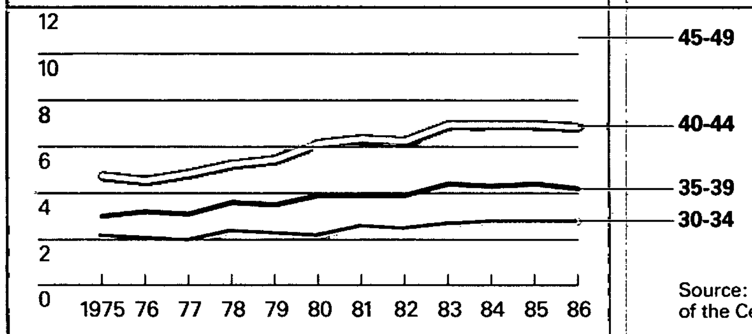
HUNGARY

5. Quality of Life Indicators

Male Death Rate by Age, 1975-86

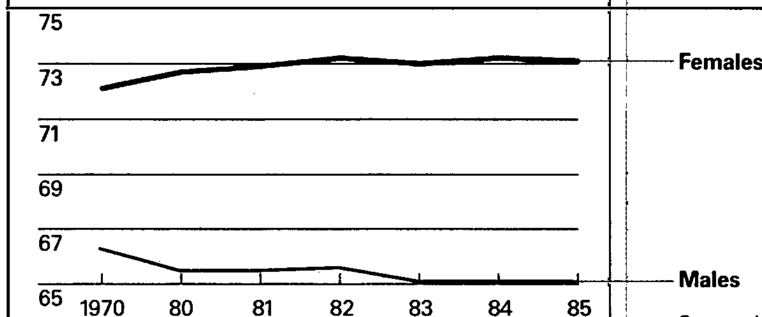
Deaths per thousand



Source: US Bureau of the Census

Life Expectancy, 1970-85

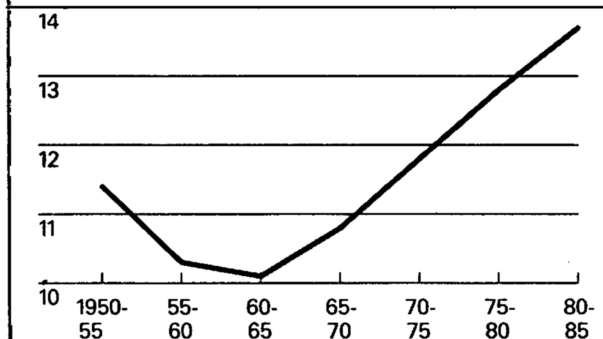
Years at birth



Source: US Bureau of the Census

Average Annual Crude Death Rate, 1950-85

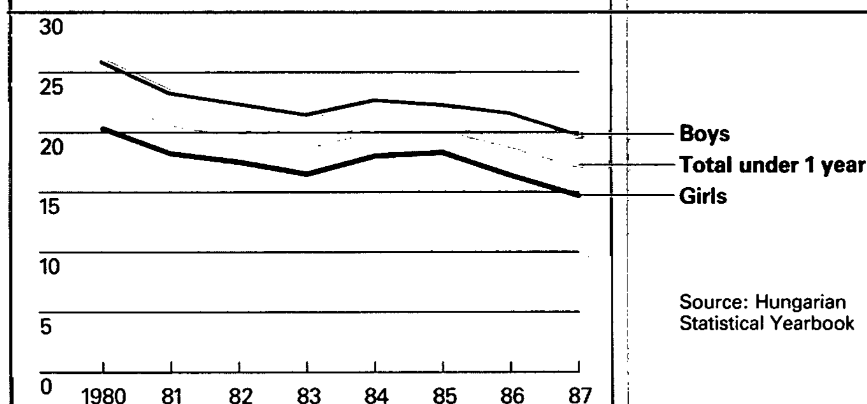
Deaths per thousand



Source: US Bureau of the Census

Infant Mortality, 1980-87

Deaths per thousand



Source: Hungarian Statistical Yearbook

- Prices subject to advance reporting. Another 13 percent of prices cannot be raised without prior reporting to the Price Office, which can deny or limit planned increases.

- Negotiated prices. Only 7 percent of prices are determined through negotiations between the government and enterprises. This arrangement allows government intervention in markets that are dominated by only a few firms or where other problems limit competition.

- Free prices. The remaining 63 percent of prices are subject only to the Import Pricing Rule, which specifies that prices should not exceed the landed cost of comparable imports, and the Law of Unfair Economic Practices, which is designed to prevent exploitative behavior by producers and retailers.

Budapest intends to increase gradually the share of consumer goods in the quasi-free-price category to about 70 percent by 1990, primarily by reducing the coverage of the advance reporting category. The government maintains the prerogative to intervene in price formation, however, because of concern about keeping inflation and social tensions in check, and it appears to still exercise considerable influence over prices through consultations with Hungary's largest producers.

Marketizing International Trade

Hungarian policymakers recognize that the economy must be better integrated into world markets in order to expose Hungarian producers to greater competition, accelerate industrial restructuring, and ultimately improve Hungary's ability to service its foreign debt. Last January, the government took the first steps toward a freer import regime, and, a few months later, a government committee under state minister and party chairman Rezso Nyers recommended reducing trade with Eastern Europe and placing trade with the Soviet Union on a hard currency basis. Although Hungary is not likely to withdraw from CEMA in the near term, it undoubtedly will take a more selective approach to participation. These steps alone, however, will not enable the Hungarian economy to shift trade rapidly toward the West, because shortages both of hard currency for imports and of competitive goods for export will persist into at least the mid-1990s.

Import Liberalization. This year, the government abolished import licenses and quotas on products—mainly machinery and spare parts—representing some 40 percent of the value of hard currency imports. Although imports of capital goods and spare parts increased by 20 to 25 percent in the first half of 1989, the Hungarian Chamber of Commerce alleges that technological development is still being hindered by high import tariffs—often in the 35- to 50-percent range—on advanced, high-technology products. In 1990, the government plans to free an additional 20 percent of imports, including metallurgical products, chemicals, and basic inputs such as wool, leather, and wood for certain light industry branches. According to a Trade Ministry official, it wants 85 percent of convertible currency imports liberalized by the end of 1991. Raw materials and energy will not be included, probably because Hungary fulfills its needs in these areas mainly through Soviet imports and because its energy sector is integrated into CEMA electricity grids as well as CEMA oil and gas pipeline networks.

The CEMA Connection. The idea of shifting trade with the Soviet Union—Hungary's largest trading partner, accounting for about 30 percent of total trade—to a hard currency basis and world prices stems from Hungarian frustration that the current system of CEMA trade and cooperation is impeding restructuring and that its reform is not likely in the foreseeable future. The Soviets are studying this option, but no firm commitment to a new trade regime has been made on either side.

There is much debate among Hungarian officials over whether the transition to hard currency accounting will pay off. Although it might attract Western joint-venture partners interested in using Hungary as a base for exporting to the Soviet Union, it probably would cause a shortrun deterioration in Hungary's hard currency trade balance. The Soviets, for example, probably would be less willing to purchase Hungarian goods, particularly machinery, that are below Western standards for hard currency, leading to a fall in Hungarian industrial production and employment. It is impossible to determine exactly how much Hungarian exports would fall, but the Ministry of Trade estimates losses would total $800 million to $1 billion, while the

Hungarian Chamber of Commerce, which is opposed to the proposed change, puts the figure at $2.0-2.2 billion. In any case, the transition to hard currency trade will not occur before 1991 at the earliest, when a new five-year planning period starts in Hungary and in the Soviet Union.

Prospects for Further Reform

A relatively broad consensus appears to be forming among party reformers and some key opposition parties—the groups that appear to be driving current policy discussions—that Hungary has no alternative to moving toward a market economy and becoming more integrated into the world economy. There is no agreement, however, on how far and how fast to proceed with reforms and how to balance competing macroeconomic goals. Hungarian economists have been debating, for example, whether Hungary can best preserve its solvency and promote an economic recovery through austerity measures or through a selective growth strategy. In response to further deterioration in Hungary's economic performance in the first half of 1989, the leadership is currently preparing at least three different options for a new three-year economic program. These options—basically a continuance of current policies, a faster reform program, and a contingency plan in the case of a rescheduling—probably will be presented to the parliament this fall and may form the basis of negotiations with the IMF over new assistance.

The leadership probably will not implement a reform program of the scope it really needs until after multiparty parliamentary elections scheduled to take place by June 1990. In fact, the "three-year" program probably will be short lived because the next government undoubtedly will want to formulate its own plan. Most of the critical reforms needed to put the economy on a sounder footing, such as cutting subsidies and allowing insolvent state enterprises to fold, are measures that only the Hungarian leadership itself can implement. In these areas, the pace of reform is largely driven by Hungarian political realities, in particular the strength of the leadership and its political will to enforce unpopular policies. As the protracted negotiations with the IMF on a renewal of the standby credit illustrate, the leadership shows little enthusiasm for hard decisions in an election year.

In the runup to the election, the leadership probably will employ only stopgap measures to stem economic deterioration, while trying to consolidate and broaden the reforms it has already initiated. The leadership, however, probably will give more attention to attracting foreign investment than to phasing out subsidies and insolvent enterprises. Budapest appears concerned that workers, whose wages have not kept pace with prices, will take to the streets if also faced with widespread unemployment. As much as one-quarter of the population already lives at or near the poverty level, according to official Hungarian statistics. The number of strikes will certainly increase over the next several years, but so far workers have remained largely apolitical and have not tried to organize a nationwide labor challenge to the leadership.

The economy's fundamental weaknesses are so deep seated—large foreign debt burden, limited hard currency earning potential, and heavy dependence on Western imports—that, even if the leadership accelerates reform, prospects for improved economic performance and living standards will be limited at least into the mid-1990s. Loose fiscal and monetary policies this year will add to inflationary pressures and make it more difficult to pursue decentralizing reforms of wages, prices, and imports in 1990.

What the West Can Do

One of the most significant contributions the West can make to Hungary's economic well-being during this difficult transition period is to provide technical and managerial expertise in a host of areas. These include:

- Developing capital markets and a service infrastructure for the private sector.
- Improving enterprise management.
- Establishing foreign sales networks.
- Retraining large numbers of workers.
- Creating a tax system that neither stifles initiative nor discourages investment.

Lowering barriers to Hungarian exports in Western markets would also be beneficial, and the costs to the West should not be excessive. The low competitiveness of many Hungarian exports, particularly in the manufactured consumer goods, engineering, and food-processing sectors, probably would constrain their growth.

In addition, Budapest is looking to Western governments to encourage foreign investment in Hungary and may in the future need to seek some form of debt relief. Over the past year, Hungarian Government officials have publicly discussed various options, including rescheduling and debt-equity swaps, to ease the country's financial burdens. Commercial banks, which hold almost 90 percent of Hungary's debt, are not willing to grant interest rate reductions or debt writeoffs, however, as they have their own profitability to consider. Thus, Budapest has so far sought financial assistance in the form of IMF and World Bank loans and Western-backed government loans to bolster its creditworthiness and maintain access to commercial credits. At some point, Hungary may be forced to seek emergency bridge loans from Western governments and the Bank for International Settlements, as it did in 1982. Under such circumstances, or in the case of other forms of financial assistance, the West can help promote reform and economic recovery by tying new funds to specific projects or performance to ensure that they are used for their intended purposes. The West can also promote modernization of the Hungarian economy more effectively through debt-equity swaps, which could help promote a transfer of Western technology and managerial skills, than through untied credits.

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POLAND - J. SACHS' PLAN

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C O N F I D E N T I A L WARSAW 12823

BRUSSELS FOR USEC

E.O. 12356: DECL: OADR
TAGS: ECON, EFIN, PL
SUBJECT: JEFFREY SACHS BRIEFS US ON HIS PROPOSED
- ECONOMIC SHOCK THERAPY FOR POLAND

1. CONFIDENTIAL -- ENTIRE TEXT.
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2. SUMMARY: HARVARD ECONOMIST JEFFREY SACHS OUTLINED HIS "SHOCK TREATMENT" ECONOMIC STABILIZATION PROGRAM FOR AMBASSADOR AND EMBOFFS ON SEPTEMBER 15. HE SEES THE TOP PRIORITIES AS CLOSING THE BUDGET GAP BY ENDING SUBSIDIES, BOLDLY ATTACKING INFLATION (AFTER A PERIOD OF "CORRECTIVE INFLATION" RESULTING FROM SHUTTING DOWN SUBSIDIES), MOVING TOWARDS A STABLE CURRENCY AT APPROXIMATELY 8,000 ZLOTIES TO THE DOLLAR AND SETTING THE STAGE FOR PRIVATIZATION AND THE INSTALLATION OF A MARKET ECONOMY. HE HOPES THAT POLAND, THROUGH ADOPTING THIS PROGRAM, WOULD ACHIEVE PRICE STABILITY BY JANUARY. HE THINKS POLAND HAS ALREADY CROSSED THE THRESHOLD OF HYPERINFLATION (WHICH HE DEFINES AS GREATER THAN 50 PERCENT PER MONTH) AND FEARS THE SOCIAL CONSEQUENCES OF THIS CONDITION -- "POLITICAL COLLAPSE." HE ARGUES THAT POLAND SHOULD TAKE ADVANTAGE OF THE PERIOD OF HYPER-INFLATION IN THE SHORT TERM TO RAISE RELATIVE PRICES. THIS WOULD CONTRIBUTE TO PRICE STABILITY FOUR TO SIX MONTHS DOWN THE ROAD, HE CONTENDS. HE BELIEVES SOLIDARITY LED GOP ECONOMIC TEAM RECOGNIZES INDEXATION AS A "TRAP" AND REALIZES THEY MUST FIND A WAY TO GET RID OF IT. HE ACKNOWLEDGES THAT REAL WAGES MAY DECLINE BY 30 PERCENT OR MORE, UNDER THE PROPOSED PROGRAM, BUT COUNTERS THAT AS A RESULT OF STABLE PRICES, IN FOUR MONTHS OR SO THERE WOULD BE NO DROP IN REAL LIVING STANDARDS. HE WOULD PARTIALLY COMPENSATE POLES IN THE SHORT TERM FOR LOSS OF SUBSIDIES THROUGH A PROGRESSIVE INDEXATION (ABOUT 70 PER CENT FOR THOSE ON FIXED INCOMES SUCH AS PENSIONERS; LESS AS INCOME LEVELS RISE).

CONFIDENTIAL

HE BELIEVES THE ROLE OF THE WESTERN COUNTRIES IS TO PROVIDE A STABILIZATION LOAN TO POLAND OF ABOUT DOLS 1 BILLION DURING THIS PERIOD IN EXCHANGE FOR POLAND DOING THE RIGHT THINGS. THIS WOULD STABILIZE THE EXCHANGE RATE AND REDUCE INFLATIONARY PRESSURES FROM IMPORT PRICES. THEY WOULD ALSO DEFER PAYMENT ON PARIS CLUB DEBT UNTIL JANUARY; COMMERCIAL BANKS WOULD HAVE TO DO THE SAME ON THEIR LOANS. THE STABLE ZLOTY WOULD ALSO HELP IMPROVE CONFIDENCE IN THE ECONOMIC PROGRAM AMONG POLES AND THUS ENHANCE ITS ACCEPTANCE. HE ENVISIONS AN IMF PROGRAM BY DECEMBER 15 AND WOULD HOPE FOR A WORLD BANK STRUCTURAL ADJUSTMENT LOAN BY MID-JANUARY. HE IS IMPRESSED BY THE QUICK ABILITY OF THE NEW ECONOMIC TEAM TO GET TO THE HEART OF KEY ISSUES AND THEIR WILLINGNESS TO CONSIDER ENORMOUS POLITICAL RISKS. WE FIND GREATER CAUTION AMONG SOLIDARITY LEADERS TO TAKE THESE RISKS AND SOME HEALTHY SKEPTICISM AMONG SOLIDARITY ECONOMISTS ON THE FEASIBILITY OF THE SACHS PROGRAM. END SUMMARY.

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3. IN A SEPTEMBER 15 MEETING WITH AMBASSADOR, HARVARD ECONOMIST JEFFREY SACHS OUTLINED THE PROGRAM HE HAS BEEN ADVOCATING TO THE GOP ECONOMIC TEAM -- VICE PREMIER AND FINANCE MINISTER BALCEROWICZ, MINISTER TRZECIAKOWSKI AND LABOR MINISTER KURON. HE DESCRIBED THE TEAM AS "CLEAR HEADED PEOPLE WHO UNDERSTAND THE RIGHT THINGS. THEY UNDERSTAND THE DIMENSIONS OF THEIR MONETARY PROBLEM. THEY KNOW THEY MUST MOVE QUICKLY TOWARDS MARKETIZATION AND THEY REALIZE THAT INDEXATION IS A TRAP AND THEY HAVE TO FIND A WAY TO GET RID OF IT," HE SAID. HE BELIEVES THAT LIBERAL ECONOMISTS WITHIN SOLIDARITY ARE HOLDING SWAY OVER THE SOCIAL DEMOCRATS AND ARE PREPARED TO BITE THE BULLET BY ACCEPTING A TOUGH BUT QUICK STABILIZATION PROGRAM.

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4. ESSENTIALLY, SACHS' PLAN IS TO CLOSE THE BUDGET DEFICIT BY ENDING SUBSIDIES. THIS WOULD RESULT IN THE HALTING OF THE PRINTING OF EMPTY ZLOTIES

C O N F I D E N T I A L SECTION 02 OF 03 WARSAW 12823

BRUSSELS FOR USEC

E.O. 12356: DECL: OADR
TAGS: ECON, EFIN, PL
SUBJECT: JEFFREY SACHS BRIEFS US ON HIS PROPOSED

WHICH HAS FUELED INFLATION IN RECENT MONTHS. THERE WOULD BE A PERIOD OF "CORRECTIVE INFLATION" EMANATING FROM THE CUT IN SUBSIDIES, BUT HE THINKS PRICE STABILITY COULD BE ACHIEVED BY JANUARY. HE WOULD ADVOCATE USING THE SHORT TERM PERIOD OF HIGH INFLATION TO RAISE RELATIVE PRICES, AND THINKS THIS WOULD CONTRIBUTE TO STABLE PRICES IN THE THREE TO FOUR MONTH TIMEFRAME. HE CITED COAL AS THE AREA WHERE THIS WOULD BE MOST DRAMATIC. HE ADVOCATES QUICKLY FREEING UP THE EXCHANGE RATE. HE THINKS IT WILL FIND ITS LEVEL AT ABOUT 8,000 ZLOTIES TO THE DOLLAR. AT THE SAME TIME HE WOULD SUBSTANTIALLY REDUCE BARRIERS TO TRADE AND FIX TARIFFS AT RELATIVELY LOW LEVELS. ACTIONS TO FREE UP PRICES WOULD CONTRIBUTE TO DEMONOPOLIZATION, AND THEN PRIVATIZATION, SETTING THE STAGE FOR INSTALLING A FREE MARKET ECONOMY.

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5. JUST AS INFLATION IS THE MAJOR PROBLEM, THE AUGUST INDEXATION LAW--A KEY CONCESSION WON BY SOLIDARITY AT THE FEBRUARY-APRIL ROUND-TABLE--IS THE BIGGEST STUMBLING BLOCK. THE LEVEL OF INDEXATION IS NOT 80 PERCENT, IT IS 150 PERCENT, SACHS ESTIMATES. HE DESCRIBES THE SOLIDARITY-LED ECONOMIC TEAM AS "LOOKING FOR A STRATEGY TO GET OFF THE TIGER." HE ACKNOWLEDGES THAT REAL WAGES MAY DECLINE 30 PERCENT OR MORE UNDER HIS PROGRAM, BUT BELIEVES THERE WOULD BE NO FURTHER DROP IN REAL LIVING STANDARDS BY THREE OR FOUR MONTHS FROM NOW. THERE WOULD BE A TRADE-OFF OF REAL WAGES FOR PRICE STABILITY. STABLE PRICES WOULD BRING FORTH GREATER PRODUCTION OF GOODS SO THAT CONSUMERS WOULD HAVE SOMETHING TO BUY WITH THEIR ZLOTYS AND AT COMPETITIVE PRICES. SACHS' PROGRAM URGES THE GOP TO MAKE ITS NOVEMBER INSTALLMENT ON INDEXATION AT 80 PERCENT, BUT END IT THEREAFTER. HE WOULD PARTIALLY COMPENSATE FOR THE LOSS OF SUBSIDIES THROUGH A PROGRAM OF PROGRESSIVE INDEXATION IN WHICH PEOPLE AT THE LOW-END OF THE INCOME SCALE (SUCH AS PENSIONERS AND OTHERS ON FIXED INCOMES) MIGHT RECEIVE 70 PERCENT OF LOST SUBSIDIES. AS INCOMES ROSE, THE LEVEL OF THIS INDEXATION WOULD DECREASE.
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6. SACHS SAID THAT ALTHOUGH THE GOP REPORTS INFLATION FOR AUGUST AT 47 PERCENT, IT REALLY IS MUCH HIGHER--PERHAPS OVER 80 PERCENT. (THE POLES CALCULATE INFLATION BY AVERAGING PRICES OVER THE MONTH RATHER THAN COMPARING PRICES ON THE LAST DAYS OF SUCCESSIVE MONTHS.) BY VIRTUE OF BEING OVER 50 PERCENT PER MONTH, THIS QUALIFIES AS HYPER INFLATION. HE SAID HE FEARS ITS SOCIAL CONSEQUENCES, WHICH HE BELIEVES WOULD BE WORSE THAN THOSE BROUGHT ABOUT BY AUSTERITY. || *
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7. IN EXCHANGE FOR DOING THE RIGHT THINGS, SACHS WOULD CALL UPON WESTERN COUNTRIES TO CONTRIBUTE TO A 1 BILLION DOLLAR STABILIZATION FUND, DEFER PAYMENT ON PARIS CLUB DEBT UNTIL JANUARY AND SUPPORT AN IMF ADJUSTMENT PROGRAM AND A WORLD BANK STRUCTURAL ADJUSTMENT LOAN. HE SAID HE HAD SOME INDICATIONS THAT THE JAPANESE GOVERNMENT WOULD BE WILLING TO CHIP IN ON A STABILIZATION LOAN. AS FOR THE PARIS CLUB, HIS SUGGESTION TO THE GOP IS THAT NOTHING BE PAID UNTIL JANUARY OR FEBRUARY. THE GOP WOULD APPEAL TO CLUB MEMBERS FOR UNDERSTANDING, PUTTING FORTH THE STABILIZATION PROGRAM AS AN EARNEST PAYMENT. A SIMILAR APPROACH WOULD BE TAKEN WITH COMMER-CIAL BANK CREDITORS. HE URGES THE GOP TO QUICKLY WORK OUT AN IMF PROGRAM; HE WOULD LIKE THE GOP TO SIGN OFF WITH THE FUND BY THE END OF OCTOBER SO THE PROPOSAL CAN BE APPROVED BY THE FUND MANAGEMENT IN TIME FOR A DECEMBER 15 FIRST TRANCHE DISBURSEMENT. ASKED ABOUT THE
C O N F I D E N T I A L SECTION 03 OF 03 WARSAW 12823

BRUSSELS FOR USEC

E.O. 12356: DECL: OADR
TAGS: ECON, EFIN, PL
SUBJECT: JEFFREY SACHS BRIEFS US ON HIS PROPOSED

DOCUMENT SUBMITTED TO THE IMF IN JUNE, HE DESCRIBED IT AS AN OUTLINE WHICH REQUIRES A

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LOT OF WORK IN FILLING IN THE NUMBERS AND GETTING THEM TO BALANCE. REGARDING THF WORLD BANK STRUCTURAL ADJUSTMENT LOAN, HE SAID THE BANK MOVES SLOWLY BUT HE WOULD HOPE THAT THE PROCESS COULD BE SET IN MOTION TO HAVE A LOAN BY FEBRUARY.

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8. ASKED ABOUT ANTICIPATED REACTION BY COMECON TRADING PARTNERS TO HIS PLAN, HE SAID THIS IS AN AREA NO ONE HAS LOOKED AT. HE ADDED THAT POLAND SHOULD MOVE TO CORRECT THE PRICE DISTORTIONS RESULTING FROM CMEA TRADE ON SUCH COMMODITIES AS OIL.

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9. SACHS BELIEVES THE SOLIARITY LED GOVERNMENT ECONOMIC TEAM IS PREPARED TO TAKE THE TOUGH MEASURES HE OUTLINED TO US EVEN IF IT INVOLVES PUTTING ITS POLITICAL CAPITAL AT STAKE. COMMENTS MADE TO THE EMBASSY BY A NUMBER OF SOLIDARITY LEADERS AND ECONOMISTS SUGGEST THAT THEY REMAIN CAUTIOUS WITH REGARD TO SACHS' PROPOSALS BOTH IN TERMS OF POLITICAL RISKS AND ECONOMIC FEASIBILITY. WHILE THERE IS PLENTY OF EVIDENCE THE NEW GOVERNMENT IS PREPARED TO MOVE FORWARD QUICKLY ON INFLATION AND THE BUDGET DEFICIT, AS WELL AS NEGOTIATING WITH THE IMF, THEY MAY NOT ACCEPT SACHS' PROGRAM LOCK, STOCK AND BARREL. FOR EXAMPLE, FOLLOWING SACHS' PRESENTATION TO THE SENATE ECONOMIC COMMMITTEE, SENATOR CESZARY JOSEFIAK REPORTED TO EMBOFF THAT HE THOUGHT SACHS' IDEAS WERE OVERLY SIMPLISTIC. HE CITED THE IMMEDIATE LIFTING OF PRICE SUBSIDIES, NOTING COAL PRICES ALONE WOULD INCREASE TENFOLD, SENDING REVERBERATIONS THROUGHOUT THE ECONOMY AND SOCIETY. HE ALSO QUESTIONED HOW CLOSELY SACHS HAD WORKED THE NUMBERS. FOR INSTANCE, HE WAS UNCERTAIN WHETHER SACHS COULD ACCURATELY CALL WHERE THE EXCHANGE RATE WOULD SETTLE. OTHER ECONOMISTS HAVE QUESTIONED WHETHER SACHS' PLAN WOULD ENJOY THE SAME RAPID SUCCESS IN POLAND AS IT DID IN BOLIVIA WHERE THE STRUCTURES OF A MARKET ECONOMY WERE MUCH MORE WIDELY IN PLACE.

10. OTHER SOLIDARITY ECONOMISTS HAVE PRIVATELY TOLD ME THAT THEY REGARD THE SACHS PRFSCRIPTIONS AS SOMETHING LIKE A SHINY NEW AUTOMOBILE WHICH IS BEING SOLD WITHOUT A SERVICE WARRANTY. THEY ESTIMATE, AND HE CONFIRMS, THAT HIS FORMULA COULD DROP THE ALREADY LOW STANDARD OF LIVING BY A FURTHER THIRTY PERCENT. MANY HERE DOUBT THAT EVEN A SOLIDARITY GOVERNMENT CAN SURVIVE A SHOCK OF THIS MAGNITUDE GIVEN THE PRESENT PUBLIC MOOD. I WOULD ANTICIPATE, AND PRIME MINISTER MAZOWIECKI SEEMED TO CONFIRM IN HIS CONVERSATION WITH SECRETARY MOSBACHER TODAY, THAT POLAND'S REPRESENTATIVES ARE LIKELY TO SEEK AGREEMENT FROM THE IMF FOR AN ADJUSTMENT PERIOD STRETCHING OVER TWO OR THREE YEARS RATHER THAN CHANCE AN IMMEDIATE PLUNGE INTO THE UNKNOWN WHICH WOULD THREATEN POLAND'S HARD-WON NEW DEMOCRACY.

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BRUSSELS FOR USEC

PARIS ALSO FOR USOECD

E.O. 12356: DECL: OADR
BODY
TAGS: EFIN, EAID, IMF, IBRD, PL
SUBJECT: POLAND - MEETING WITH
- FINANCE MINISTER BALCEROWICZ
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2. SUMMARY: AMBASSADOR AND ECONCOUNS MET
WITH FINANCE MINISTER BALCEROWICZ THIS MORNING
(SEPTEMBER 21). BALCEROWICZ WILL LEAVE FRIDAY
MORNING FOR WASHINGTON TO ATTEND IMF-WORLD BANK
MEETINGS EARLY NEXT WEEK. IN HIS EIGHTH DAY
IN OFFICE, BALCEROWICZ IS RUSHING TO COMPLETE

A DOCUMENT OUTLINING POLAND'S SITUATION AND MAZOWIECKI GOVERNMENT'S STRATEGY FOR DEALING WITH IT TO PRESENT DURING BILATERALS AT BANK-FUND MEETING AND TO G-24 MEETING IN BRUSSELS ON SEPTEMBER 26. ALTHOUGH HE COULD NOT PROVIDE NUMBERS OR OTHER SPECIFICS, HE SAID PAPER WILL PLEDGE TO IMPLEMENT TOUGH MEASURES QUICKLY TO DEAL WITH INFLATION, TO ACCELERATE PACE IN MAKING INSTITUTIONAL CHANGES TOWARDS A MARKET ECONOMY AND A CONVERTIBLE CURRENCY, AND TO NAIL DOWN AN ADJUSTMENT PROGRAM WITH THE IMF AS QUICKLY AS POSSIBLE. TO GET THROUGH CRITICAL EARLY STAGE OF IMPLEMENTATION, GOP MAY REQUEST STABILIZATION LOAN OF "SEVERAL HUNDRED MILLION DOLLARS." HE EMPHASIZED THIS REQUEST WOULD BE LINKED TO ECONOMIC MEASURES AND WOULD NOT REPEAT NOT BE A SUBSTITUTE FOR REFORM. GOP MAY ALSO ASK FOR ADDITIONAL FOOD AID TO KEEP SHELVES STOCKED OVER NEXT 100 DAYS, ESPECIALLY AS CHRISTMASTIME APPROACHES. END SUMMARY.

3. BALCEROWICZ DESCRIBED OUTCOME OF SEPTEMBER 18-19 MEETING WITH IMF EUROPEAN DIRECTOR RUSSO AS VERY POSITIVE PRELIMINARY STEP TOWARDS AN ADJUSTMENT PROGRAM. HE SAID THE FUND IS WILLING TO DO EVERYTHING IT CAN TO SPEED UP THE PROCESS (A TEAM WILL COME IN EARLY OCTOBER TO CRUNCH NUMBERS, WORKING FROM THE OUTLINE PROGRAM PRESENTED TO THE FUND IN JUNE), BUT THE PROCESS WOULD NONETHELESS TAKE TWO MONTHS. HE IS APPRECIATIVE THAT FUND IS DOING WHAT IT CAN, AS QUICKLY AS IT CAN, BUT EMPHASIZED THE CATCH-22 SITUATION POLAND IS IN. IT GOES AS FOLLOWS: NEEDED AID (INCLUDING PARIS CLUB RESCHEDULING) IS LINKED TO AN IMF AGREEMENT, AN IMF AGREEMENT TAKES AT LEAST TWO MONTHS, BUT POLAND NEEDS HELP NOW. HE SAID FUND WANTS POLAND TO BEGIN TO IMPLEMENT RADICAL MEASURES RIGHT AWAY IN ANTICIPATION OF AN ADJUSTMENT PROGRAM BUT CAN'T DISBURSE UNTIL AT LEAST DECEMBER IN SUPPORT OF THESE MEASURES. HE UNDERSTANDS THIS STANCE, BUT FINDS IT DIFFICULT TO CARRY THROUGH AS POLAND'S RESERVES ARE IN BAD SHAPE. HE SAID THE MOST CRITICAL QUESTION IS WHAT TO DO IN THE INTERIM.

4. HE SAID A DOCUMENT IS IN PREPARATION FOR PRESENTATION AT THE BILATERALS DURING THE SEPTEMBER 25-26 IMF-WORLD BANK MEETING AND THE SEPTEMBER 26 G-24 MEETING IN BRUSSELS. HE SAID PAPER WILL FOCUS ON NEED FOR HELP IN SHORING UP RESERVES AND FOOD SUPPLIES OVER THE NEXT 100 DAYS. IT WILL OUTLINE MEASURES POLAND IS PREPARED TO TAKE BOTH IN THE AREA OF STABILIZATION--TRIMMING BACK INDEXATION AND REMOVING

SUBSIDIES--AND IN IMPLEMENTING INSTITUTIONAL CHANGES--MARKETIZATION AND CURRENCY CONVERTIBILITY--AT AN ACCELERATED PACE. HE SAID POLAND NEEDS FINANCIAL SUPPORT TO ACCOMPLISH THESE REFORMS. THE PAPER WILL LIKELY REQUEST A STABILIZATION LOAN FROM WESTERN COUNTRIES. AFTER WE PRODDED HIM FOR A FIGURE, HE SAID "SEVERAL HUNDRED MILLION DOLLARS." THE LOAN REQUEST WOULD BE LINKED TO ECONOMIC MEASURES AND WOULD NOT BE A SUBSTITUTE FOR REFORM, HE EMPHASIZED. HE SAID HE WILL DO HIS BEST TO GET A COPY OF THE DOCUMENT TO US IN ADVANCE OF HIS
C O N F I D E N T I A L SECTION 02 OF 02 WARSAW 13002

BRUSSELS FOR USEC

PARIS ALSO FOR USOECD

E.O. 12356: DECL: OADR
TAGS: EFIN, EAID, IMF, IBRD, PL
SUBJECT: POLAND - MEETING WITH

MEETINGS WITH U.S. OFFICIALS AND THE G-24 MEETING IN BRUSSELS.

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5. IN DISCUSSING PROBLEMS OVER THE NEXT 100 DAYS, HE EMPHASIZED DEALING WITH INFLATION, CLOSING THE BUDGET DEFICIT, TACKLING THE INDEXATION DILEMMA, AND ASSURING FOOD DELIVERIES. ON INDEXATION, HE SAID MEASURES WERE UNDER CONSIDERATION TO ASSURE THAT THOSE WHO ALREADY HAVE RECEIVED BIG BENEFITS (WELL IN EXCESS OF THE 80 PERCENT FIGURE AGREED TO AT THE ROUND TABLE) WILL NOT GET FURTHER BENEFITS AS A MULTIPLE OF THE EXCESS. HE ALSO TALKED OF MEASURES ASSURING THAT WAGE INCREASES LAG PRICE HIKES, RESTORING TAX DISCIPLINE AND REMOVING SUBSIDIES ESPECIALLY IN THE AREA OF FOOD PROCESSING. HE SAID THE MAZOWIECKI GOVERNMENT HAD TO DEAL WITH A SERIOUS PERCEPTION PROBLEM. AS FOOD PRICES INCREASE, PRICES TO FARMERS MOVE UPWARDS BUT MUCH MORE SLOWLY. HE DESCRIBED THIS AS A NATURAL PROCESS, BUT HE SAID THE PEOPLE DON'T UNDERSTAND THAT.
IN THIS REGARD, HE ALSO EMPHASIZED THE VERY CRITICAL NATURE OF CONSULTATIONS WITH TRADE UNIONS ON THE GOP ECONOMIC PROGRAM. HE SAID HE WAS SCHEDULED TO MEET WITH UNION LEADERS TODAY TO EXPLAIN HIS PROGRAM.

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6. IN ADDITION TO HIS BILATERALS WITH U.S. OFFICIALS, HE SAID HE WOULD BE MEETING WITH IMF MANAGING DIRECTOR CAMDESSUS AND THE ITALIAN

FINANCE MINISTER. DAVIS
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